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U.S. HOUSE OF REPRESENTATIVES

SUMMARY OF COMMITTEE AMENDMENT TO H.R. 4170 (TAX REFORM ACT OF 1984)

As Adopted by the

COMMITTEE ON WAYS AND MEANS

ON MARCH 1, 1984

MARCH 5, 1984

Prepared for the Use of the Committee on Ways and Means by its staff

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I. INTRODUCTION

This pamphlet summarizes the principal provisions of the amendment adopted by the Committee on Ways and Means on March 1, 1984, in the nature of a substitute to H.R. 4170 as previously reported by the Committee on Ways and Means.

In agreeing to this committee amendment on a bi-partisan basis, the members of the committee are committed to utilizing the revenues raised in this tax reform bill to reduce the current unacceptable level of Federal deficits and not to provide opportunities for new Federal spending programs.

The summary descriptions contained in this pamphlet are intended to be informative, rather than inclusive. The official legislative history is contained in the committee report. A supplemental report to accompany the bill will be filed Monday evening, March 5, 1984. This report (H. Rept. 94–432, Part 2) will completely supersede the earlier report filed on October 21, 1983.

I. LEGISLATIVE BACKGROUND

This document provides a summary of the principal provisions of the Committee amendment to H.R. 4170, as reported by the Committee on Ways and Means on October 21, 1983 (H. Rep. No. 98-432). The Committee amendment (the Tax Reform Act of 1984) consists of 12 titles, as amended in Committee markup on November 16, 1983, and February 29 and March 1, 1984, which were previously ordered reported by the Committee as individual bills or separate provisions on July 26-27, October 4-6, and 18-19, 1983. These are the titles of the Committee amendment to H.R. 4170:

Title I—Tax Freeze and Tax Reform Provisions Generally [1]

Title II—The Life Insurance Tax Act of 1984 (H.R. 4065, as amended);

Title III—The Private Foundation Tax Treatment Revision Act of 1984 (report and recommendations of the Subcommittee on Oversight, with amendments);

Title IV—The Tax Law Simplification and Improvement Act of 1984 (H.R. 3475, as amended, including H.R. 3592 and H.R. 3593, as amended);

Title V—The Permanent Tax Treatment of Fringe Benefits Act of 1984 (H.R. 3525, as amended);

Title VI—The Technical Corrections Act of 1984 (H.R. 3805, as amended);

Title VII—The Tax-Exempt Bond Limitation Act of 1984 (including H.R. 2504, as amended);

Title VIII—Miscellaneous Revenue Provisions (H.R. 699, H.R. 2476, H.R. 2831, H.R. 3096, H.R. 3173, as amended; plus additional miscellaneous amendments adopted on November 16, 1983, and March 1, 1984);

Title IX—The Social Security Disability Benefits Reform Act of 1984 (H.R. 3755, as amended);

Title X—The Medicare Budget Reconciliation Amendments of 1984;

Title XI—Amendments to Trade Adjustments Assistance Programs;

Title XII—Highway Use and Diesel Fuel Taxes.

This document is prepared for the use of Members of Congress and the Committee on Ways and Means, and is intended to serve only as a convenient condensation of the principal provisions of the Committee amendment to H.R. 4170. The Committee explanation will provide the official legislative history of the Committee amendment. The Committee explanation will be filed (as a supplemental committee report); on Monday, March 5, 1984, and should be available on Tuesday, March 6, 1984.

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[1] Title I of the Committee amendment includes Title I of H.R. 4170 as reported, with certain amendments (The Tax-Exempt Entity Leasing Act of 1984), plus a tax freeze amendment and tax shelter and other reform provisions considered by the Committee on February 29 and March 1, 1984.

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II. SUMMARY OF THE COMMITTEE AMENDMENT TO H.R. 4170

SECTION 1: PROVISIONS (AS AMENDED) OF H.R. 4170 AS REPORTED

A. Tax-Exempt Entity Leasing

Present law

The Federal income tax benefits of ownership of property generally include accelerated depreciation deductions and investment tax credits. Essentially, the law is that the economic substance of a transaction, not its form, determines who is entitled to the tax benefits associated with ownership. Thus, in a lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

The tax benefits of ownership are generally allowed only for property used for a business or income-producing purpose. They are not available for property that is owned by governmental units and tax-exempt organizations. Property that is used (though not owned) by a tax-exempt organization or a domestic governmental unit qualifies for accelerated cost recovery (ACRS) or other depreciation deductions but generally does not qualify for investment credits (nontaxable use restriction). For example, property used under a lease by one of those entities is ineligible for the investment credit. A statutory exception to the nontaxable use restriction provides that qualified rehabilitation expenditures for a building leased to a tax-exempt organization or a governmental unit can qualify for the rehabilitation tax credit. Also, one court has held, and the Internal Revenue Service (IRS) has ruled, that investment credits can be claimed where a governmental unit essentially contracts not for the use of property itself, but rather for a service to be provided by the owner of the property.

Property used by a foreign government or person is not subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States, then, in general, ACRS deductions are slowed down and no investment credit is allowed.

The bill

In general, the bill reduces the tax benefits available for certain property that is leased to or otherwise used by tax-exempt entities. Under the bill, tax-exempt entities include the United States, any State or local governmental unit, possessions of the United States, and most agencies and instrumentalities of any of the foregoing. The term also includes organizations (other than farmers' cooperatives described in Code section 521) exempt from United States income tax and certain organizations that were formerly exempt. The term also includes certain foreign persons or entities.

The bill generally requires that ACRS or other depreciation deductions for property used by tax-exempt entities be computed using the straight-line method over a recovery period equal to the greater of the present class life of the property under the Asset Depreciation Range (ADR) system (40 years in the case of 15-year real property) or, in the case of property subject to a lease, 100 percent (125 percent in the case of 15-year real property) of the term of the lease. In the case of 15-year real property, this provision applies to the extent of use of a type or types specified in the bill, but only if more than 20 percent of the property is so used. Special depreciation rules are provided for certain high technology property which is tangible personal property.

The bill also provides criteria for determining whether a transaction that is structured as a service contract or other arrangement (including a partnership or other pass-through entity) should be treated as a lease for purposes of the depreciation and investment credit provisions of the bill. The rehabilitation credit will be denied for real property that is subject to the slower depreciation rules provided by the bill, but only if the rehabilitation expenditures are, or acquisition of the building to be rehabilitated is, financed in whole or in part with the proceeds of obligations the interest on which is exempt from Federal income tax under section 103(a).

The bill does not apply to property leased for a short term.

The bill generally applies to property placed in service by the taxpayer after May 23, 1983, and to property used under an agreement entered into after that date. However, transitional rules are provided.

B. Life Insurance Tax Provisions

1. Company taxation

Under present law, life insurance companies may be taxed on different tax bases. As a consequence, different companies derive varying degrees of benefit from the various reserve special deductions generally allowable only to life insurance companies and reserve computation rules of present law.

In lieu of the present law three-phase pattern of taxation which applies to life insurance companies, the bill provides a new single-phase tax structure. This structure embodies the tax rules applicable to corporations generally except that certain special rules apply to address issues unique to the life insurance industry.

a. Computation of the deduction for reserves

Under the bill, deductions for additions to reserves more closely reflect each company's liabilities to policyholders than do solvency reserves used for State law purposes. Further, the deductions are computed on the basis of uniform rules regardless of the particular assumptions used for purposes of computing statutory reserves.

Under these rules, a life insurance company can deduct an amount equal to the excess of the higher of (1) the net surrender value of the contracts or (2) the Federally prescribed reserve, over the amount of the reserve for tax purposes at the end of the prior year. The Federally prescribed reserve is the reserve computed using assumptions that generally reflect the minimum assumptions permitted to be made under most State laws.

b. Limitation on mutual company deductions

A mutual life insurance company is owned by its policyholders. These policyholders receive distributions from the company which may represent price reductions or other policyholder benefits, interest, or returns on the policyholders' investment in the enterprise.[1] Under the bill, amounts distributed by a mutual company to policyholders are, in effect, fragmented, and no deduction is allowed at the company level for amounts distributed to policyholders in their capacity as owners of the company. This is accomplished by means of an ownership differential provision. Under this provision, each mutual company's deductions for payments and credits to policyholders are reduced by the amount of an imputed return on the company's equity. There is a special 5-year transition rule for certain high surplus mutuals.

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[1] In contrast, a stock life insurance company is owned by shareholders. Although a stock company may pay policyholder dividends to its policyholders, such amounts would generally include only price reductions and policyholder benefits.

The bill also mandates a study in which the Treasury would analyze the operation of the ownership differential provision in its first 3 years.

c. Stock life insurance subsidiaries of mutual companies

As a general rule, under the bill, a stock life insurance subsidiary of a mutual life insurance company is treated as a stock company for tax purposes. However, for purposes of computing the limitation on mutual company deductions, the equity of a stock subsidiary is included in the mutual parent.

d. Special rule for small companies

Under the bill, a small life insurance company is allowed a deduction equal to 60 percent of the first $3 million of its otherwise taxable income. This deduction phases out as otherwise taxable income increases from $3 million to $15 million. The amount of this deduction is computed on the basis of a controlled group and does not apply to income related to noninsurance activities. A small company is one the assets of which (computed on the basis of an affiliated group including both insurance and noninsurance members) are less than $500 million.

e. Rate reduction

All life insurance companies are allowed a deduction equal to 25 percent of their otherwise taxable income. This deduction is computed on the basis of a controlled group and does not apply to income related to noninsurance activities.

f. Tax-exempt income

Under present law, liabilities to policyholders are treated as funded proportionately out of taxable and tax-exempt income. The bill generally continues this approach.

g. Reinsurance

The provision under which the Treasury is granted authority to reallocate income, deductions, assets, reserves, credits, and other items in the case of related party reinsurance contracts is retained and broadened in its application.

h. Definition of a life insurance company

For purposes of determining whether a company qualifies as a life insurance company, funds held with respect to contracts that do not involve permanent purchase rate guarantees are not to be treated as insurance reserves.

i. Effective date

Generally, the effective date for provisions dealing with the taxation of life insurance companies is January 1, 1984. Income that would otherwise result from recomputation of reserves (including section 818(c) recomputations and statutory-to-tax recomputations) and the change in accounting for policyholder dividends at the beginning of 1984 is forgiven under the bill.

The amount of deferred gain from operations held in the policyholder surplus account of the company (the Phase III account)

would be frozen at its 1983 year-end level and distributions from such account would be taxed when distributed under the present law rules, which are retained.

2. Life insurance products

a. Definition of life insurance

Present law does not contain a definition of life insurance or of a life insurance contract. It does, however, contain temporary rules for purposes of determining whether benefits paid under certain flexible premium products qualify as life insurance benefits exempt from income tax. The bill adopts a definition that is based on the temporary rules contained in present law. A contract is treated as a life insurance contract if it meets (1) a "cash value accumulation" test, or (2) a "guideline premium" test and "cash value corridor" test. Under the cash value accumulation test a contract qualifies if the cash value accumulated under the contract does not exceed the cash value which would arise in a traditional whole life policy assuming a reasonable interest rate is used in computing cash value. Under the guideline premium limitation, contracts are disqualified if the amount of the policyholder's investment in the contract exceeds a traditional level of investment. The cash value corridor disqualifies contracts which build up excessive amounts of cash value relative to life insurance risk. Special transitional rules apply to existing contracts and contracts that may be issued in 1984.

For contracts that fail to meet the definition at any time, the pure insurance portion of the contract (i.e., the difference between the face amount and the cash surrender value) will be treated as term life insurance. The cash surrender value will be treated as a deposit fund and income earned on the fund will be taxed currently.

b. Annuities

Under the bill, the present law exception from the 5-percent penalty for distributions of income allocable to investments within 10 years is repealed. Thus, the penalty generally will apply to distributions prior to age 59-1/2. In addition, if the owner of a deferred annuity dies prior to annuitization, the income in the annuity will be included in the decedent's last income tax return.

c. Group-term life insurance

The antidiscrimination rules and the limitation on the exclusion from income of premiums for group-term benefits are extended to retired employees. These rules would not apply to coverage in place under existing group plans on September 27, 1983.

d. Policyholder loans

Under the bill, the deduction for interest paid on policyholder loans is limited. The limitation for an individual is $250,000 ($500,000 for a joint return) multiplied by the deficiency interest rate. For businesses, the limitation is the aggregate of $500,000 per individual policy times the deficiency interest rate. The bill contains carryover rules for the unused deduction limitation. The new

rules generally are effective for policies issued after September 27, 1983.

3. Nondeductible contributions to individual retirement plans

Under present law, an individual generally is entitled to deduct the amount contributed to an individual retirement account or annuity or used to purchase retirement bonds (IRAs). The maximum amount that can be contributed is limited. Except for tax-free rollovers, no nondeductible contributions may be made to an IRA. An annual 6-percent excise tax applies to prohibited nondeductible contributions (i.e., excess contributions) held in an IRA. Under the provision, certain nondeductible IRA contributions (up to the nondeductible limit) are not treated as excess contributions subject to the 6-percent annual excise tax. The nondeductible contribution may not exceed $1,750.

The provision is effective for taxable years beginning after December 31, 1983.

C. Revision of Private Foundation Provisions

1. Charitable deduction rules

Under present law, contributions by individuals of cash or property to private nonoperating foundations (and certain other charitable organizations) generally are deductible up to 20 percent of the donor's adjusted gross income (Code sec. 170(b)(1)(B)). The bill raises this limitation to 30 percent for gifts of cash and ordinary-income property, but retains the 20-percent limitation for all gifts of capital-gain property.

The bill also provides that contributions to private nonoperating foundations of certain appreciated stock are deductible at the stock's fair market value (rather than at the present-law limitation of the donor's basis plus 60 percent of the appreciation). The increased deduction applies only to the extent that the cumulative total of donations by a donor (and family members) to private nonoperating foundations of stock in a particular corporation is less than 10 percent of the value of all outstanding stock of that corporation.

In addition, the bill extends to private nonoperating foundations the same rules on carryovers of charitable contributions exceeding the percentage limitations as apply under present law for contributions by individuals to public charities and private operating foundations (sec. 170(d)).

These changes made by the bill apply to contributions made after 1984. The increased deduction for contributions of certain appreciated stock will not apply to contributions made after 1994.

2. Excise tax on investment income

The bill reduces from two to one percent the rate of the excise tax on net investment income of private foundations (sec. 4940), effective for post-1984 taxable years, but only if the foundation's payout for charitable purposes (computed as a five-year average) is increased by an equivalent amount.

Also, the bill exempts from the section 4940 excise tax any private operating foundation that previously had been publicly supported for at least 10 years (or was in existence on January 1, 1983), that has a governing body broadly representative of the general public (with at least 75 percent consisting of persons unrelated to the foundation), and none of whose officers otherwise are disqualified persons. This amendment applies to post-1984 taxable years.

3. Mandatory payout rules

The bill limits the amount of grant administrative expenses which may be counted as qualifying distributions for purposes of meeting the minimum payout requirement (sec. 4942), effective for

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post-1984 taxable years, to 15 percent of the amount of grants, gifts, and contributions made by the foundation, computed on the basis of a five-year average. The limitation does not apply to administrative expenses incurred directly for the active conduct of an exempt activity.

4. Divestiture of excess business holdings

The bill generally retains the divestiture rules of present law (sec. 4943) with respect to "grandfathered" excess business holdings which were held by private foundations on May 26, 1969, with certain modifications.

In the case of an unusually large gift or bequest after 1969 of diverse or complex excess business holdings, the bill provides the Internal Revenue Service with discretionary authority to permit an additional five-year period for divestiture on a showing by the foundation of good cause plus diligent efforts to dispose of the holdings within the five-year period permitted under present law.

5. Expenditure responsibility and reliance rules

The bill exempts from the expenditure responsibility requirements imposed on foundation grantors (sec. 4945) grants to those private operating foundations which the bill exempts from the two-percent excise tax on net investment income (see above), effective for post-1984 grants.

The Treasury Department is to review its expenditure responsibility regulations for purposes of modifying requirements which are found to be unduly burdensome or unnecessary. Also, Treasury regulations are to be amended to extend to five years the advance ruling period during which qualifying new organizations are considered public charities, and to permit greater reliance on IRS classifications of new charitable organizations in the first five years of their existence.

6. Foundation support for voter registration drives

The bill retains all requirements of present law limiting private foundation support for voter registration drives (sec. 4945(f)) except the requirement that the voter registration drive must be conducted in five or more States; the latter requirement is repealed effective January 1, 1984. As under present law, the registration drive must be nonpartisan, and cannot be confined to one election period.

7. Abatement of first-tier penalty taxes

The bill provides the Internal Revenue Service with discretionary authority to abate the automatic first-tier penalty taxes (other than the sec. 4941 tax on self-dealing) if the foundation establishes that the violation was due to reasonable cause and not to willful neglect, and corrects the violation. This provision applies to taxable events occurring after 1984.

8. Definitions

The bill provides that the lineal descendants who are considered members of the family of a substantial contributor or other disqualified person, and thus themselves are considered to be disqualified persons (sec. 4946), are limited to the individual's children,

grandchildren, great-grandchildren, and their spouses, effective January 1, 1985.

In addition, the bill provides rules under which a person's status as a substantial contributor (sec. 507(d)) terminates in certain circumstances after 10 years with no connection to the foundation, effective for post-1984 taxable years. Also, the bill provides special retroactive relief from the excise tax on self-dealing in a particular case where continued status as a disqualified person had triggered tax on a 1978 transaction, provided that the foundation received fair market value.

9. Public disclosure requirements

The bill provides that, beginning in 1985, private foundation notices which must be published annually in a newspaper (sec. 6104(d)) are to include the telephone number of the foundation's principal office. Also, the Internal Revenue Service is directed to enforce fully the present-law rules concerning Form 990-PF information returns.

10. Games of chance

The bill exempts from the unrelated business income tax (sec. 513) income derived by nonprofit organizations from conducting certain games of chance, provided that State or local law as of October 5, 1983, permits such games to be conducted only by nonprofit organizations. This provision applies retroactively to games of chance conducted after June 30, 1981.

D. Tax Simplification Provisions

1. Estimated income tax for individuals

The individual estimated income tax rules of present law are simplified and clarified by the bill. Generally, an individual will be required to make estimated tax payments (including withholding payments) equal to the lesser of 80 percent of the current year's tax or 100 percent of the prior year's tax; penalties will be based on the underpayment from this amount. Payments based on annualized income will be allowed. The Secretary may waive the penalty for failure to make payments by reason of a casualty, disaster or other unusual circumstance where it would be inequitable to impose the penalty. Estimated tax payments of the alternative minimum tax will be required.

The provision will be effective for taxable years beginning after 1984.

2. Domestic relations

a. Transfers of property between spouses or incident to divorce

Under present law, gain is recognized on certain transfers of property in exchange for marital rights of a spouse or former spouse. The bill provides that property transfers between spouses or, if incident to divorce, between former spouses, will not result in the recognition of gain or loss. The transferee will hold the property at the transferor's basis. Also, investment tax credits will not be recaptured.

The provision will generally be effective for transfers after the date of enactment of the bill. The bill also allows taxpayers to elect to have this provision apply to transfers after December 31, 1983, or to transfers on or before the date of enactment.

b. Alimony

Under present law, alimony is deductible by the payor and includible in the income of the payee. The bill revises the rules relating to the definition of alimony. Generally, only cash payments that will terminate on the death of the payee spouse will qualify as alimony. The present law requirement that the payment be based on a legal support obligation will be repealed. Payors will be required to furnish to the IRS the social security number of the payee spouse. A $50 penalty for failure to do so will be imposed.

The provision will generally be effective for divorce or separation agreements or orders executed after 1984.

c. Dependency exemption

The bill provides that the $1,000 dependency exemption for a child of divorced or separated parents generally will be allocated to the custodial parent unless the custodial parent signs a written

declaration that he or she will not claim the exemption for the year. Each parent may claim the medical expenses that he or she pays for the child, for purposes of computing the medical deduction.

Income from certain sheltered workshops will not be taken into account in determining the dependency exemption.

The provision will be effective for taxable years beginning after 1984.

d. Innocent spouse relieved of liability in certain cases

Under present law, a spouse may be relieved of liability where he or she signs a joint return and there was a substantial omission of income attributable to the other spouse. The bill extends these rules to situations involving claims of grossly erroneous deductions and credits and would replace the substantial omission of income test with a substantial understatement of tax test. Also, the bill overrides community property laws in certain situations where it is equitable to do so.

e. Gift and estate tax treatment of certain property settlements

The bill conforms the estate tax treatment with respect to transfers of property to a former spouse under certain property settlements with the present law allowing a gift tax exemption for such transfers. The bill also extends the period to enter into a property settlement agreement in order to avoid gift tax. The provision will apply to gifts made and to estates of decedents dying after date of enactment of the bill.

3. At-risk rules

The bill amends the at-risk limitation on the investment tax credit by providing that the base for the credit will be reduced by nonrecourse indebtedness related to the property (i.e., a loan on which there is no personal liability). Qualified commercial financing, defined as financing from an unrelated party regularly engaged in commercial lending where no more than 80 percent of all financing for the property is nonrecourse, will be excluded from the limitation. In the case of an S corporation, recourse financing at the corporate level that is provided by a qualified commercial lender will be considered recourse financing at the shareholder level if the debt is related to property used by the corporation in an active trade or business with at least 3 full-time non-owner employees.

The bill will exempt, from both the loss limitation rules of section 465 and the investment tax credit at-risk rules, the active trade or business activities of a regular closely-held business corporation. To qualify, a trade or business must have 3 full-time non-owner employees and its out-of-pocket expenses must exceed 15 percent of gross income. Non-closely held corporations will continue to be exempt from the at-risk rules.

The bill also requires that, for a lessee to be eligible to claim the full investment tax credit, the lessee must be at risk for rental payments the present value of which is equal to at least 30 percent of the fair market value of the property.

The investment tax credit provisions generally will apply to property placed in service in taxable years ending after the date of enactment of the bill. At the taxpayer's election, these provisions will apply as if included in the Economic Recovery Tax Act of 1981. The changes to the section 465 rules will apply to taxable years beginning after December 31, 1983.

4. Estate tax revisions

a. Permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests

Under the rules adopted by the Tax Reform Act of 1969, a charitable interest in a split-interest trust (i.e., a trust which is part charitable and part noncharitable) must be in certain specified forms to be deductible for Federal income, gift, and estate tax purposes. Present law permits defective governing instruments of charitable split-interest trusts which were created pursuant to wills executed before January 1, 1979, to be amended to conform to the 1969 Act rules by December 31, 1981.

The bill provides a permanent rule permitting reformation of governing instruments of charitable split-interest trusts which do not meet the requirements of the 1969 Act rules where the instrument evidences an intent to comply with the 1969 Act rules (or the reformation begins within a specified period) and the actuarial values and durations of the charitable and noncharitable interests in the trust generally remain the same before and after the reformation.

This provision will be effective with respect to reformations made after December 31, 1978.

b. Alternate valuation date election

Under present law, the value of property includible in the decedent's gross estate for Federal estate tax purposes generally is determined on the date of the decedent's death. However, the executor of the decedent's estate may elect to have the value of all property included in the gross estate determined as of the alternate valuation date (which generally is six months after the decedent's death). The election to use the alternate valuation date may be made only on a timely filed Federal estate tax return. Also, under present law, the Federal income tax basis of property acquired from a decedent generally is its value for Federal estate tax purposes.

The bill provides that the election to use the alternate valuation date may be made only where both the total value of all property in the gross estate and the Federal estate tax liability of the estate are reduced by making the election. The bill would also allow the alternate valuation election to be made on the first estate tax return filed (whether filed timely or late).

This provision will be effective with respect to estates of decedents dying after the date of enactment of the bill.

5. Foreign tax provisions

a. Resident aliens

The bill makes several changes in the tax provisions affecting foreign income and foreign taxpayers. It provides standards for determining whether an alien individual is a resident of the United States. Under these standards, an individual who spends substantial time in the United States in any year or over a three-year period will generally be a U.S. resident. A permanent resident for immigration purposes will be a U.S. resident, also. The bill prevents married nonresident aliens from using the community property laws of their home country to split income for U.S. tax purposes. These provisions are generally effective for taxable years beginning after 1984.

b. Foreign personal holding company attribution rules

The bill clarifies the family attribution rules for determining when a foreign corporation is a foreign personal holding company. It also prevents avoidance of U.S. tax by interposition of a foreign trust or another foreign entity between a foreign personal holding company and a U.S. taxpayer. These provisions generally apply to taxable years beginning after 1983.

c. Ordinary income treatment under section 1248

The bill clarifies the rules that tax the previously untaxed earnings and profits of a controlled foreign corporation at ordinary income rates when its U.S. owner disposes of the shares or liquidates the corporation. It prevents later double taxation of those earnings and profits and double crediting of associated foreign taxes. It also treats direct ownership of a controlled foreign corporation like indirect ownership for the purpose of these rules. These provisions are generally effective for transactions occurring after the date of enactment.

d. Coordination of subpart F with foreign personal holding company provisions

The bill coordinates the foreign personal holding company rules with the controlled foreign corporation rules. It provides that shareholders of a controlled foreign corporation (that is also a foreign personal holding company) are subject to the controlled foreign corporation rules to the extent that income taxable under those rules exceeds income taxable under the foreign personal holding company rules. This provision applies to taxable years beginning after the date of enactment.

e. Stapled stock

The bill contains provisions regarding so-called stapled stock. It provides generally that if a foreign and a domestic corporation are stapled entities, the foreign corporation generally will be treated as domestic. In addition, if two domestic corporations are stapled entities, each will be treated as owning the other. These provisions are generally effective on the date of enactment.

6. Miscellaneous Treasury administrative provisions

The bill makes a number of minor amendments relating to Treasury administrative provisions. The bill simplifies certain requirements of the Treasury Department to make reports to the Congress, removes the $1 million limitation of the Treasury working capital fund, increases the authorization limit from $1 million to $10 million on the revolving fund for the redemption of real property, allows the Secretary of the Treasury to accept gifts and bequests for the Treasury Department, allows an extension of time for court review of a jeopardy assessment where the government is not promptly served, removes the $1 million limitation on the Secretary of the Treasury's special authority to dispose of obligations, allows the Internal Revenue Service a minimum of 60 days to assess unpaid taxes shown on an amended return, provides the government a lien on the assets of all financial institutions which issue an unpaid guaranteed draft for the payment of taxes, and allows the disclosure of windfall profit tax returns to State tax agencies.

The bill also repeals the occupational tax on manufacturers of stills and condensers, allows drawback claims for distilled spirits excise taxes in certain cases, provides for disclosure of alcohol fuel producers to administrators of State alcohol laws, and repeals the stamp requirement for distilled spirits containers.

7. Tax Court provisions

The bill allows certified public accountants and enrolled agents authorized to practice before the Internal Revenue Service to represent taxpayers in small claim cases before the Tax Court and increases the small claims case dollar limit from $5,000 to $10,000. The title of the Tax Court "commissioners" will be changed to "special trial judges". The bill provides that the Tax Court may prevent public disclosure of trade secrets or other confidential information. Finally, Tax Court judges will no longer be required to retire at age 70.

8. Simplification of income tax credits

In general, the bill groups existing income tax credits into logical categories and provides uniform tax liability limitations and carryover rules. The business credits (i.e., investment tax credit, targeted jobs credit, alcohol fuels credit, and ESOP credit) will be combined into one credit and allowed up to 100 percent of the first $25,000 of tax liability and 85 percent of the remainder. The research credit will continue to be allowable against 100 percent of tax liability. A 3-year carryback and 15-year carryforward period on a FIFO basis will be allowed for the business credits.

This provision will apply to taxable years beginning after 1983.

9. Miscellaneous tax provisions

a. Rollover of certain partial distributions from qualified plans

Under the bill, distributions of less than the balance to the credit of an employee under a qualified pension, profit sharing, or stock bonus plan or a tax-sheltered annuity contract can be rolled over,

tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution will be permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment as prescribed by the Secretary of the Treasury.

The provision will be effective for distributions made after the date of enactment of the bill, in taxable years ending after that date.

b. Treatment of certain related party transactions

The bill amends the related party rules (sec. 267) so that a taxpayer would generally be placed on the cash method of accounting for purposes of deducting business expenses and interest owed to a related party cash basis taxpayer. These rules will be extended to amounts accrued by a partnership to its partners and vice versa.

Also, the bill extends the loss disallowance and accrual provisions to transactions between corporations which are members of a controlled group of corporations, using a 50-percent control test. This provision will not apply to transactions with a controlled DISC.

These provisions generally will apply to taxable years beginning after 1983. However, the provision will not apply to (1) interest on indebtedness incurred on or before September 29, 1983, or incurred pursuant to a contract binding on that date and all times thereafter and (2) other expenses made pursuant to a contract which was binding on September 29, 1983, and at all times thereafter.

c. Preferred stock eligible for small business corporation stock treatment

Under present law, a taxpayer is allowed to deduct, as an ordinary loss, up to $50,000 ($100,000 in the case of a joint return) of loss on the disposition of certain common stock of a domestic small business corporation. The bill, which applies to stock issued after the date of enactment, extends ordinary loss treatment to preferred stock of qualified small business corporations.

d. Medical expense deduction for certain lodging

Under present law, individuals who itemize deductions may deduct certain expenses paid for medical care to the extent the expenses exceed 5 percent of adjusted gross income. Amounts paid for transportation primarily for and essential to medical care are treated as expenses paid for medical care. Amounts paid for lodging while away from home, however, do not qualify for the deduction.

Under the bill, certain expenses for lodging while away from home to receive medical care as an outpatient at a hospital or certain similar medical care facilities are treated as expenses paid for medical care, up to a limit of $50 per eligible person per day. This provision is effective for taxable years beginning after 1983.

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e. Study of gross income tax

The bill provides for a study by the Treasury Department of a simplified gross income tax, to be submitted to the Congress within 6 months after date of enactment of the bill.

10. Repeal of certain obsolete provisions (deadwood)

Three provisions (Code sections 405, 409, and 1251) are repealed as deadwood.

E. Fringe Benefit Provisions

The Code defines gross income for income tax purposes as including "all income from whatever source derived" and specifies that it includes "compensation for services" (sec. 61). Similarly, the social security and unemployment insurance payroll taxes (FICA and FUTA) and income tax withholding generally apply to all remuneration for employment, including noncash remuneration.

Under present law, specific statutory exclusions are provided for income and employment tax purposes for certain types of employee benefits, such as health benefits. However, the Economic Recovery Tax Act of 1981 (P.L. 97-34) extended through December 31, 1983, a moratorium on the issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits.

Under the bill, certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage and benefit base for purposes of social security and other employment taxes. The excluded fringe benefits are those that qualify under one of the following five categories as defined in the bill: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, (4) a de minimis fringe, or (5) a qualified tuition reduction. Special rules apply with respect to certain parking or eating facilities provided to employees, on-premises athletic facilities, and demonstration use of an employer-provided car by auto salespersons.

In the case of a no-additional-cost service, a qualified employee discount, employee parking, a subsidized eating facility, or a qualified tuition reduction, the exclusion applies with respect to benefits provided to officers, owners, or highly compensated employees only if the benefits are also made available to other employees on a nondiscriminatory basis.

Any fringe benefit that does not qualify for exclusion under the bill or under another specific statutory provision is includible in gross income, and subject to employment taxes, at the excess of its fair market value over any amount paid by the employee for the benefit.

The provisions of the bill generally take effect on January 1, 1984, except that the tuition reduction exclusion applies with respect to education furnished after June 30, 1984.

F. Technical Corrections

This title contains technical, clerical, conforming and clarifying amendments to provisions enacted by the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revision Act of 1982, the Highway Revenue Act of 1982, the Social Security Amendments of 1983 and other recently enacted tax legislation.

G. Tax-Exempt Bond Provisions

1. Mortgage subsidy bonds

a. Extension of qualified mortgage bond authority

The bill extends the tax exemption for qualified mortgage bonds to bonds issued prior to January 1, 1989. State mortgage bond volume caps are to be reduced, in any year, by the volume of qualified veterans' mortgage bonds issued in the prior year. (An exception is provided for veterans' mortgage bonds issued pursuant to certain authorizations made prior to 1984.) Veterans' mortgage bonds are also to be subject to the January 1, 1989, sunset date. Additionally, the bill makes mortgage subsidy bonds (including veterans' mortgage bonds) subject to a reporting requirement.

b. Mortgage credit certificates

The bill allows State and local governments, for any year, to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs will entitle homeowners to credits not exceeding 50 percent (but not less than 10 percent) of interest on indebtedness incurred with respect to qualifying residences. The credits are to be subject to the existing eligibility requirements for qualified mortgage bonds. Credits not usable in any year by a homeowner may be carried over against a later year's tax liability.

Under the bill, the amount of MCCs distributable by a State or local government is equal to 15 percent of the principal amount of exchanged mortgage subsidy bond authority. The amount of exchanged authority cannot exceed 9 percent of the average volume of single-family mortgages in the State during the prior three years. For States and localities which issued less than their statutory ceiling of qualified mortgage bonds in 1983, a 5-year phase-in of MCC authority is to apply.

MCCs are subject to the January 1, 1989, sunset for qualified mortgage bonds.

2. Limited equity cooperatives

The bill provides that limited equity housing cooperatives may elect to be eligible for either mortgage subsidy bond or industrial development bond (IDB) financing. If a cooperative elects to be eligible for IDB financing, the members of the cooperative may not receive deductions for interest and taxes on the property.

3. Industrial development bonds

a. Volume caps on private activity bonds

Under the bill, private activity tax-exempt bonds are subject to statewide volume caps. The caps are applicable to industrial devel-

opment bonds (IDBs) and student loan bonds issued within the State. Bonds used to finance projects for multifamily residential rental property are exempted from the caps. Additionally, IDBs used to finance convention or trade show facilities, airports, docks, wharves, and certain mass commuting facilities are exempted from the caps where the facilities are owned for tax purposes by a State or local governmental unit.

The caps are to be set at $150 for each resident of the State (according to the most recent census estimates). The amount of the caps will be reduced to $100 per capita after 1986 to reflect the sunset for small issue IDBs. Within each State, the cap is to be allocated among State and local issuers according to rules similar to those used for allocation of mortgage subsidy bond authority.

The bill provides for a three-year carryover (six years in the case of pollution control bonds) of a State's volume cap to finance specific projects or for student loan bonds. The carryover is not applicable for small issue IDBs. Additionally, for States whose 1983 volume exceeds the statewide cap, a two-year phase-in is applicable.

b. Restrictions on cost-recovery for IDB-financed property

The bill repeals three of the four present law exceptions to the rule requiring straight-line cost recovery deductions (over ACRS periods) for IDB-financed property. However, the bill allows projects for multifamily residential rental property to receive full accelerated cost recovery over ACRS periods.

c. Limitations on IDBs for land or existing facilities

The bill eliminates the use of IDBs to purchase agricultural land or existing facilities in most cases. Exceptions are provided for substantial rehabilitations and up to $250,000 of IDB financing for first-time farmers or ranchers. Use of IDB proceeds to purchase land for nonagricultural purposes is limited to 25 percent of bond proceeds.

d. Restrictions on small issue IDBs

The bill allows small issue IDBs only to the extent that not more than $40 million in IDB financing is outstanding for each beneficiary of the small issue.

Under the bill, the capital expenditure limits applicable to small issue IDBs are to be applied to an entire project rather than to individual users (as under present law). For example, a multi-story office building is to be treated as a single project and the limitations applied to the entire building.

The bill increases from $20 million to $25 million the size of projects receiving Urban Development Action Grants (UDAGs) which qualify for small issue IDB financing.

e. Federally guaranteed bonds

The bill denies a tax exemption for obligations guaranteed directly or indirectly by the Federal Government, including bonds issued in connection with Federal deposit insurance. Exceptions are provided for guarantees by various housing-related agencies and student loan guarantees, and for guarantees of pollution control bonds

by the Small Business Administration. Bonds used to finance multifamily residential rental are property exempt from the Federal guarantee rule.

f. Non-Code tax exemptions

The bill requires bonds issued pursuant to tax exemptions outside the Internal Revenue Code (including bonds issued by U.S. possessions) to meet the requirements of the tax-exempt bond provisions of the Code, including the volume limitation and other restrictions applicable to industrial development bonds.

g. Arbitrage

The bill extends the arbitrage rules applicable under present law to mortgage subsidy bonds to all private activity bonds other than bonds used to finance multifamily residential rental property.

h. Advance refundings

The bill eliminates the rule allowing advance refundings of bonds used to finance certain convention and trade show facilities, airports, docks, wharves, mass commuting facilities and parking facilities.

i. Further tax-exempt bond provisions

The bill denies tax exemption where bonds are used by a principal user of the facility being financed or a partner of the principal user. The bill permits IDB financing for the multifamily residential rental property portion of a mixed-use project. The bill prohibits the use of IDBs to finance liquor stores, sky boxes, private airplanes, and gambling establishments. Further, under the bill, the public approval requirements for private activity bonds are modified in the case of certain airports located in more than one jurisdiction. The bill provides a tax exemption for obligations issued by the Pennsylvania State University and makes certain other changes in the rules regarding IDBs.

4. Effective dates

The provisions regarding mortgage subsidy bonds and industrial development bonds are generally effective for obligations issued after December 31, 1983. In the case of bonds issued in connection with Federal deposit insurance, the denial of tax exemption applies to obligations issued after April 14, 1983. The bill provides appropriate transition rules for purposes of certain of the limitations on industrial development bonds.

H. Miscellaneous Revenue Matters

1. Capital gain treatment for portion of gain on sale of condominium units converted from existing structures

Under present law, the entire gain on the conversion of property into condominiums and the individual sale of those condominiums generally is treated as ordinary income to the seller. As a result, owners of property who wish to convert it into condominiums often sell the entire property to another person who converts the property and sells the individual condominium units. If the entire property is sold in one sale prior to conversion, the owner generally will receive capital gain treatment with respect to the gain on the sale of the property.

In general, the bill provides that a taxpayer can elect to treat a portion of the gain realized on the sale or exchange of the condominium units acquired in the conversion of qualified real property into condominium units as capital gain. The amount treated as capital gain will be the excess of the fair market value of the property over the property's adjusted basis at the time of the conversion. Any additional gain on the disposition of the units will be treated as ordinary income. The provision will apply to conversions after the date of enactment of the bill in taxable years ending after such date.

2. No gain recognized from net gifts made before March 31, 1983

Present law taxes income "from whatever source derived," including the benefit resulting from the discharge of one's indebtedness by another party (Code sec. 61(a)(12)). Present law also imposes a gift tax on certain transfers for less than adequate consideration (sec. 2501). Liability for the gift tax is on the donor of the transferred property.

A donor may transfer property pursuant to an agreement with the donee that the donee will pay any gift tax arising from the transfer (i.e., make a "net gift"). On June 15, 1982, the U.S. Supreme Court ruled in *Diedrich* v. *Commissioner*, that the discharge of a donor's liability for gift tax by the donee of a net gift gives rise to income to the donor to the extent that the gift taxes exceeded the donor's adjusted basis in the transferred property.

The bill would provide that no income would be recognized to donors who made net gifts before March 4, 1981 (the date on which an initial decision by the Court of Appeals held that the donor in the *Diedrich* case recognized income).

3. Disaster loss deduction where taxpayer ordered to demolish or relocate residence in disaster area because of disaster

Present law allows a deduction for nonbusiness casualty losses to the extent such losses exceed $100 per loss and 10 percent of ad-

justed gross income for the taxable year. In general, a deduction is allowed only when the casualty (e.g., storm, flood or earthquake) causes actual physical damage to the taxpayer's property.

The bill provides that certain taxpayers whose residences are located in a Federally declared disaster area, and who are ordered by a State or local government to demolish or relocate their residences, may deduct any loss attributable to the demolition or evacuation order as a casualty loss. The provision applies to taxpayers whose residences have been rendered unsafe for use as a residence as a proximate result of the disaster. This provision is retroactive to January 1, 1982.

4. Foreign investment companies

a. Offshore commodity funds

Under present law, taxpayers contend that a foreign corporation that is widely held by U.S. persons may establish a subsidiary to invest in U.S. commodities markets without any of the parties incurring U.S. tax. They also contend that when the U.S. shareholders eventually dispose of their shares in the foreign corporation they will be subject to tax at only the capital gains rate. This provision applies generally to sales or exchanges on or after September 29, 1983.

The bill will, in certain cases, apply the accumulated earnings tax to earnings from U.S. investments, even after those earnings pass through corporate solution as dividends or interest. It will also generally treat gains of U.S. shareholders from those investments as ordinary income. This provision applies generally to distributions received on or after May 23, 1983.

b. Corporations formed to straddle

Taxpayers may attempt to avoid the tax straddle rules by forming corporations, typically foreign corporations, to take positions to offset their own. The bill will treat such stock ownership as a position for the purposes of the straddle rules. This treatment will prevent a taxpayer from recognizing losses when the taxpayer uses a corporation for straddling purposes. This provision applies to positions established on or after May 23, 1983.

5. Application of cash or deferred arrangement rules to pre-ERISA money purchase plans

The Employee Retirement Income Security Act of 1974 (ERISA) provided that amounts deferred by an employee pursuant to a cash or deferred arrangement or a salary reduction arrangement under a tax-qualified profit-sharing, stock bonus, or money purchase pension plan are excluded from the employee's income if (1) the plan was in existence on June 27, 1974, and (2) the applicable requirements of prior law were satisfied. This tax treatment for then existing plans was preserved, pending study by the Congress of the appropriate treatment for cash or deferred and salary reduction arrangements.

Under the Revenue Act of 1978, amounts deferred by an employee after 1979 pursuant to a cash or deferred arrangement under a tax-qualified profit-sharing or stock bonus plan are excluded from

the employee's income only if certain requirements added by the Act are met. No new rules were provided by the 1978 Act for salary reduction arrangements under money purchase pension plans.

Under the bill, amounts deferred by an employee pursuant to a salary reduction arrangement under a money purchase pension plan are excluded from the employee's income if the plan was in existence on June 27, 1974, and contributions by employees and the employer do not exceed the levels permitted under the plan's contribution formula on that date. In addition, the plan must satisfy rules added by the 1978 Revenue Act with respect to employee participation and prohibited discrimination in favor of officers, shareholders, or highly compensated employees.

The bill will apply to plan years beginning after the date of enactment. The rules in effect prior to ERISA will apply for plan years beginning after December 31, 1979, and before the date of enactment.

I. Social Security Disability Benefits

1. Standards of disability

a. Standard of review for terminations of disability benefits (medical improvement)

Section 901 of the bill requires the continuation of benefits for those individuals whose conditions have not medically improved to the point of ability to perform substantial gainful activity (SGA), with the following exceptions:

(1) benefits may be terminated if new evidence shows the beneficiary has benefited from advances in medical therapy or technology or from any vocational therapy to the point of ability to perform SGA; and

(2) benefits may be terminated if new evidence (including new diagnostic or evaluation techniques not available or used at the original determination) shows the impairment or impairments to be less severe than originally thought.

Section 901 also provides for termination of benefits whether or not the impairment has improved if the person is currently working at the SGA level, or if the prior determination of entitlement to benefits was either clearly erroneous at the time it was made, or was fraudulently obtained. The Social Security Administration (SSA) would be authorized to secure additional medical evidence to reconstruct initial decisions in cases where there is no medical evidence supporting the initial decision.

b. Study on evaluation of pain

Section 902 requires the Secretary of Health and Human Services (HHS), in conjunction with the National Academy of Sciences, to conduct a study concerning the questions of using subjective evidence of pain in determining whether a person is under a disability, and the state of the art of preventing, reducing or coping with pain. A report is to be submitted to the Committee on Ways and Means and the Senate Committee on Finance by April 1, 1985.

c. Multiple impairments

Section 903 provides that in determinations of disability, the Secretary must consider the combined effect of all of an individual's impairments whether or not each or any impairment would alone be severe enough to qualify the person for benefits.

2. Disability determination process

a. Temporary moratorium on mental improvement reviews

Section 904 provides for a temporary delay on reviews of all mental impairment disabilities until the listings for mental impairments have been revised in consultation with the Advisory Council,

and are published in final form in regulations. Regulations must be published no later than nine months after the date of enactment. The delay also would be imposed on review of all continuing disability investigation (CDI) mental impairment cases after June 7, 1983.

b. Face-to-face evidentiary hearing

Section 905 provides for the implementation, no later than January 1, 1985, of face-to-face evidentiary interviews at the State agency level for medical termination cases. Under this provision, the State agency would send the beneficiary a preliminary notice of an unfavorable decision and the claimant would have 30 days in which to request a face-to-face meeting before a formal determination is made. The reconsideration level would be abolished for all initial CDI decisions completed after January 1, 1985.

Section 905 also requires the Secretary to initiate demonstration projects with respect to face-to-face evidentiary meetings at the initial level of State agency determination for new applicants and report to the Congress by April 1, 1984, and projects begun no later than July 1, 1984.

c. Payments of benefits during appeal

Section 906 provides on a permanent basis for the continuation of benefits during appeal in all CDI cases through the decision of an Administrative Law Judge (ALJ). Where the ALJ's decision is adverse to the beneficiary, such benefit payments would be subject to recoupment as under present law. The bill also requires the Secretary to report to Congress on the impact of the provision by July 1, 1986.

d. Qualifications of medical professionals

Section 907 provides that no determination that a person is not under a disability with respect to mental impairments until a psychiatrist or psychologist employed by the State agency has completed the medical portion of the case review as well as the assessment of residual functional capacity.

e. Consultative examinations

Section 908 provides that regulations be promulgated regarding consultative examinations.

3. Miscellaneous provisions

a. Application of uniform standards for disability determinations

Section 909 provides that the notice and comment provisions of Section 553 of the Administrative Procedure Act (APA) would apply to benefit programs under Title II of the Social Security Act. The bill leaves in place the existing exceptions in Section 553 of the APA referring to the issuance of interpretive rulings, as well as purely administrative procedures.

b. SSA compliance with certain Federal court decisions

Section 910 requires SSA to either apply the decisions of circuit courts of appeal to at least all beneficiaries residing within States within the circuit, or appeal the decision to the Supreme Court. This provision applies to circuit court opinions issued after the date of enactment as well as to those opinions which the Secretary still has the opportunity to appeal to the Supreme Court as of the date of enactment.

c. Payment from trust funds for costs of rehabilitation services

Section 911 repeals the requirement, in those cases where there is a medical recovery, that a disabled beneficiary must perform 9 months of SGA to qualify the vocational rehabilitation (VR) provider for reimbursement. In addition, payment for services to VR providers would be authorized for beneficiaries who, without good cause, refuse to continue to accept services or fail to cooperate with the rehabilitation process.

d. Advisory Council on Medical Aspects of Disability

Section 912 creates an Advisory Council on Medical Aspects of Disability composed of independent medical and vocational experts to provide advice and recommendations to the Secretary on disability standards, policies and procedures. The Council would include 10 members to be appointed by the Secretary (with the Commissioner of Social Security an ex-officio member) and must include at least one psychiatrist, one rehabilitation psychologist and one medical social worker.

The Council would be authorized to periodically convene a larger representative group to assure the input of appropriate professional and consumer organizations, and would also be authorized to set up temporary short-term task forces to examine some specialized issues.

Section 912 further provides that the Council must be appointed no later than 60 days after enactment of the bill (to assure the timely participation of the Council in the review of the mental impairment listings) and would expire on December 31, 1985.

e. Staff attorneys

Section 913 requires the Secretary of HHS to establish higher grade attorney positions to enable staff attorneys to achieve qualifying experience necessary to be appointed to ALJ positions.

4. Effective date

Except as otherwise provided, these provisions will apply only with respect to cases involving disability determinations pending in HHS or in court on or after the date of enactment.

J. Medicare Budget Reconciliation Amendments

1. Payment and coverage — related changes

a. Payment for outpatient diagnostic laboratory tests

A fee schedule would be established for all clinical laboratory services provided to medicare beneficiaries except for hospital inpatients. The schedule may initially be established on a carrier or regional basis. A national fee schedule would be required to be established within three years.

The initial fee schedule would be set at a level no higher than 60 percent of prevailing charges and would be updated annually by the same percentage increase as the Consumer Price Index. The clinical laboratory would be required to bill the program directly and would be required to accept medicare assignment. For these services the laboratory would be reimbursed 100 percent of the fee schedule amount (or, if lower, the billed charge), with the deductible and coinsurance waived.

Where the physician directly provides, or supervises the provision of clinical laboratory services, and where he agrees to accept medicare assignment, the physician would be reimbursed at 100 percent of the fee schedule amount (or, if lower, the billed charge) with deductible and coinsurance waived. Physicians not accepting assignment would continue to be reimbursed at 80 percent of the fee schedule amount or (if lower, 80 percent of the billed charge) with the usual deductible and coinsurance applying.

b. Coverage of hepatitis B vaccine

Medicare would cover hepatitis B vaccine furnished to medicare patients in hospitals and renal dialysis facilities. The part B deductible and coinsurance would be waived.

c. Pacemaker reimbursement review and reform

The Secretary would be required to issue guidelines on the indications for, and frequency of, transtelephonic monitoring of pacemakers. If guidelines are not established by October 1, 1984, the proposal would establish a frequency schedule for certain types of pacemakers, with exceptions for medicially documented cases.

The Secretary would be required to study reimbursement rates for physicians' services with respet to pacemakers, taking into consideration changes in surgical procedures that have taken place over the years.

The Food and Drug Administration (FDA) is to establish a registry of all implanted pacemakers.

d. Payment for debridement of mycotic toenails

Medicare would cover debridement of mycotic toenails no more frequently than every 60 days, unless medical necessity is documented.

e. Payment for costs of hospital-based mobile intensive care units.

Certain services of mobile intensive care units could be covered under mediare part A under specified circumstances in States with Statewide prospective payment systems.

f. Payment for physicians' services furnished to hospital inpatients

The committee agreed to to the following committee amendment to the committee bill:

Prevailing charges for physicians' services provided to hospital inpatients would be frozen at the June 30, 1984 level, effective July 1, 1984 through June 30, 1985. There would be no provision for a catch-up in subsequent years.

Physicians would be required to accept medicare assignment for all services provided to medicare hospital inpatients until six months after the Congress receives the Secretary's report on including physician payments under the diagnostic related group (DRG) prospective payment system, which under the bill would be due by July 1, 1985.

To participate in medicare, each hospital would be required to obtain from each doctor on its medical staff an agreement to accept assignment for any medicare inpatient services rendered in the hospital.

2. Miscellaneous administrative changes

a. Presidential appointment of and pay level for the Administrator of the Health Care Financing Administration

The bill would provide for the Presidential appointment of the Administrator of the Health Care Financing Administration with the advice and consent of the Senate. The position and pay of the Administrator would be increased to Level IV of the Executive Schedule.

b. Permit limited representation on peer review organization (PRO's)

One person who is a governing body member, officer or managing employee of a health care facility would be permitted to be a member of the governing board of a PRO with less than 15 members; in the case of a PRO with more than 15, two such members would be permitted.

c. Access to home health services

The bill would permit a physician, who has a financial interest in a home health agency that is sole community provider, to carry out the certification and plan-of-care functions for patients who receive services from the agency, and to delete from the list of dis-

qualified physicians uncompensated officers or directors of incorporated home health agencies.

d. Repeal of special tuberculosis treatment requirements

The bill would repeal the special tuberculosis requirements under medicare and medicaid.

e. Indirect payment of supplementary medical insurance benefits

The bill would permit part B payments to be made to a health benefits plan where payment is accepted by the physician or other supplier as payment in full.

f. Including podiatrists and dentists in the definition of physician for certain purposes

A podiatrist (acting within the scope of his practice) would be considered a physician for purposes of coverage of outpatient physical therapy, which requires that the patient be "under the care of a physician." A podiatrist or dentist (acting within the scope of his practice) would be considered a physician for purposes of coverage of outpatient ambulatory surgery in a surgeon's office.

g. Establishment by physical therapist of plans for physical therapy

Either a physical therapist or a physician would be permitted to establish a plan of treatment for physical therapy services. The physician would still be required to review the plan periodically, as under existing law.

h. Access to records of subcontractors

The bill would increase from $10,000 to $50,000 the minimum value of the agreement between a medicare provider and a subcontractor for purposes of requiring access to subcontractor records.

i. Medicare recovery against certain third parties

The bill would establish the right of medicare to recover directly from certain third parties, such as workers compensation, auto and liability insurance.

j. Use of accrediting organizations for certain entities furnishing services

The bill would authorize the Secretary to rely on certain accrediting organizations in determining whether rural health clinics, laboratories, clinics, rehabilitation agencies, including outpatient rehabilitation facilities, psychiatric hospitals and public health agencies meet medicare requirements (and clarify the Secretary's authority with respect to ambulatory surgical centers).

k. Confidentially of accreditation surveys

The bill would extend to surveys by the American Osteopathic Association and other national accreditation organizations the same disclosure protections given JCAH surveys.

l. Thirty-day coverage for services furnished by a home health agency after agreement has been terminated

The bill would change from the end of the calendar year to 30 days after termination of a home health agency agreement, the ending of coverage for services provided under a plan of care established prior to the termination date of the participation agreement.

m. Termination of agreements with entities where owners and certain individuals have been convicted of certain offenses

The bill would authorize the Secretary to exclude from medicare participation any entity in which ownership or controlling interest is held by a person convicted of a program-related criminal offense, or in which an officer, director, agent or managing employee was convicted of such a criminal offense.

n. Elimination of the Health Insurance Benefits Advisory Council

The bill repeals section 1867 of the Social Security Act, thus eliminating the Health Insurance Benefits Advisory Council.

o. Open enrollment for health maintenance organizations and competitive medical plans

The Secretary would be directed to designate one 30-day period each year in which all of the medicare participating HMO's in a geographic area must have an open enrollment period.

p. Date for report on physician's payments

The bill would specify the date on which the Secretary of Health and Human Services is required by present law to report to Congress recommendations on the advisability and feasibility of making payments for physician's services furnished to hospital inpatients based on a DRG system and legislative recommendations thereon. The report would be due July 1, 1985.

q. Flexible sanctions for noncompliance with requirements for end-stage renal dialysis facilities

The bill would allow the Secretary to apply intermediate sanctions to ESRD facilities when noncompliance does not justify decertification of such facilities.

r. Removing costs of nurse anesthetists from DRG-based payments

For a temporary period, hospitals employing certified registered nurse anesthetists (CRNAs) would be reimbursed on a reasonable cost basis, as determined by the Secretary, for services of CRNAs. The Secretary would be required to report with recommendations on payments to CRNAs under the prospective payment system.

s. Determination of hospital area wage index

The Secretary would be directed to establish criteria under which a hospital could demonstrate, for purposes of medicare prospective payment, that the area wage index inaccurately reflects

the labor market conditions it actually faces; adjustments in payment could be made where the Secretary deems appropriate. The Secretary would also be directed to consult with the Department of Labor and BLS to develop an improved area wage index.

t. Definition of bona fide emergency services

Existing law provides for reduced payment for physicians' services in hospital outpatient departments except for "bona fide emergency services." The bill would establish the following statutory definition of emergency services:

> Services provided in hospital emergency rooms after the onset of a medical condition manifesting itself by symptoms of sufficient severity that the absence of immediate medical attention could reasonably be expected by a prudent layperson possessing an average knowledge of health and medicine to result in (a) placing the patient's health in jeopardy; (b) serious impairment to bodily functions; (c) serious dysfunction of any bodily organ or part; or (d) development or continuance of severe pain.

u. Delay of effective date for single-rate for skilled nursing facilities.

The single-rate for hospital-based freestanding skilled nursing facilities would be delayed from October l, 1983, until April 1, 1984.

K. Trade Adjustment Assistance Programs

Title XI contains three amendments to the trade adjustment assistance (TAA) programs for workers and firms under the Trade Act of 1974, as amended by the Omnibus Budget Reconciliation Act of 1981. These programs were recently reauthorized for a two-year period until September 30, 1985, under Public Law 98-120. The amendments become effective on the date of enactment of the bill.

SECTION 2:

ADDITIONAL PROVISIONS OF THE BILL ADOPTED

SUBSEQUENT TO REPORTING OF H.R. 4170

A. "Tax Freeze" and Related Provisions

1. Foreign earned income

Under present law, the maximum amount of income earned abroad excluded from taxable income is $80,000 for 1983, and is scheduled to increase in $5,000 annual increments to a permanent level of $95,000 in 1986. The bill freezes the amount of the exclusion at $80,000 until 1988 and increases it in $5,000 increments to $95,000 in 1990.

2. Expensing of business personal property

Under present law, the amount of personal property which businesses may elect to expense each year is scheduled to increase from $5,000 in 1983 to $7,500 in 1984 and 1985 and to $10,000 thereafter. The bill freezes the maximum amount that can be expensed at $5,000 through 1987, increasing it to $7,500 in 1988 and 1989 and $10,000 thereafter.

3. Investment credit for used property

Under present law, the maximum amount of used property eligible for the investment credit is scheduled to increase from $125,000 to $150,000 in 1985. The bill freezes the amount eligible for the credit at $125,000 through 1987, after which this limit increases to $150,000.

4. Net interest exclusion

Under present law, starting in 1985, individuals will be able to exclude 15 percent of interest income to the extent such income exceeds certain interest deductions, up to a maximum exclusion of $450 for single persons and $900 for married couples. The bill repeals this net interest exclusion.

5. Limits on pension plans

Under present law, the dollar limits on the contributions to and benefits from tax-qualified pension plans are scheduled to be indexed for inflation in 1986. The bill freezes the dollar limits at current levels until 1988, after which such limits will be indexed.

6. Employee stock ownership plans

Under present law, the tax credit for employer contributions to an employee stock ownership plan (ESOP) is scheduled to increase from one-half of one percent of payroll in 1983 and 1984 to three-

fourths of one percent in 1985. The bill freezes the credit at the current rate through 1987.

7. Estate and gift tax rate

Under present law, the maximum estate and gift tax rate is scheduled to be reduced from 60 percent in 1983 to 55 percent in 1984 and 50 percent in subsequent years. The bill freezes the rate at 60 percent until 1988 and reduces the rate to 55 percent in 1988 and 50 percent thereafter.

8. Windfall profit tax on newly discovered oil

Under present law, the windfall profit tax rate on newly discovered oil is scheduled to decline from 25 percent in 1983 to 22.5 percent in 1984, 20 percent in 1985, and 15 percent in 1986 and subsequent years. The bill freezes the rate at 25 percent through 1987, and reduces the rate to 22.5 percent for 1988, 20 percent for 1989 and 15 percent for 1990 and future years.

9. Percentage depletion on secondary and tertiary production

Under present law, the allowance for percentage depletion on secondary and tertiary oil production expired at the end of 1983. The bill corrects the technical error leading to this termination and clarifies that percentage depletion will not be available after 1983 for secondary or tertiary production from proven properties transferred after 1974.

10. Cigarette excise tax

Under present law, the 16-cents-per-pack excise tax on cigarettes is scheduled to be reduced to 8 cents on October 1, 1985. The bill reduces the tax only from 16 cents per pack to 12 cents, for the period October 1, 1985 through December 31, 1987.

11. Excise tax on distilled spirits

Under present law, the excise tax on distilled spirits is $10.50 per proof gallon. The bill increases the tax to $14.25 per proof gallon for the period October 1, 1985 through December 31, 1987.

12. Telephone excise tax

Under present law, the 3-percent telephone excise tax is scheduled to expire after 1985. Under the bill, the 3-percent tax remains in effect through 1987.

13. Finance leasing

Under present law, liberalized leasing rules for limited use property and fixed price purchase options become effective on January 1, 1984. The bill postpones that effective date for four years. Present liberalized leasing rules are continued for up to $150,000 of farm equipment. In addition, a general transition rule is provided.

14. Leasing regulations

The Treasury is prohibited from issuing regulations distinguishing leases from conditional sales agreements or other financing arrangements. The prohibition, which expires December 31, 1987,

does not apply with respect to certain arrangements involving motor vehicles.

B. Partnership and Other Pass-through Entities

1. Allocations of partnership income or loss

a. Contributed property

Under present law, a partnership may elect to allocate income, gain or loss, and depreciation or depletion with respect to contributed property to reflect variations between the basis of the property and its fair market value. In the absence of the election, income, and gain or loss with respect to contributed property can be effectively shifted among members of the partnership.

Under the committee bill, the special allocation of income, gain or loss, and depreciation or depletion with respect to contributed property will be made mandatory so that a partnership will generally have to allocate pre-contribution gain or loss to the contributing partner. The provision applies to contributions made after March 31, 1984.

b. Partnership losses

Under present law, retroactive allocation of partnership deductions to partners entering late in the year is prohibited. Nonetheless, it may be possible to accomplish such an allocation through the use of tiered partnerships or, in the case of cash method partnerships, by delaying actual payment for accrued expenses.

With respect to the tiered partnership technique, the bill requires income, gain, loss, deduction, and credit passing from a subsidiary partnership to a parent partnership to be allocated equally among the days in the parent's taxable year for which it has an interest in the subsidiary. Further, for cash basis partnerships, certain items such as taxes, interest, and rents are to be allocated proportionately over the periods to which they relate, so that a partner can deduct only those items actually accrued while he is a partner. The provision applies to items paid or accrued after March 31, 1984.

The bill also provides for regulations with respect to determining a partner's allocable share of partnership liabilities (and therefore the amount of partnership losses that can be taken into account by partners) which will produce economically sound results and, among other things, overrule the holding of the U.S. Claims Court in *Raphan* v. *United States*.

2. Conversion or deferral of income

a. Gain or loss on contributed property

Present law provides that if certain ordinary income property of a partnership is distributed to a partner, its character as ordinary income property is preserved in the hands of the distributee for at least five years. No comparable rule applies to property contribut-

ed to a partnership. Thus, it may be possible to change the character of property from ordinary income to capital gain or from capital loss to ordinary loss through a contribution to a partnership.

Under the bill, the ordinary income or loss character of unrealized receivables contributed to a partnership will be preserved in the hands of the partnership. Further, the ordinary income or loss character of inventory items would be preserved in the hands of the partnership for five years. Built-in losses on capital assets contributed to a partnership are treated as capital losses if recognized by the partnership within 5 years. The provision applies with respect to property contributed after March 31, 1984.

b. Organizational fees and other capital expenditures

Under present law, amounts expended to organize or promote a partnership, generally, must be capitalized. Other payments for property or services may also be required to be capitalized. It has been suggested that these capitalization requirements may, in effect, be avoided when the payee is also a partner by allocating a greater share of income to that partner.

The bill provides that when a partner performs services for, or transfers property to, a partnership and receives a related allocation of partnership income or gain, the transaction will be treated as occurring between the partnership and a person who is not a partner. Thus, the amount of the allocation is to be capitalized. The provision applies to transactions occurring after March 1, 1984.

c. Disguised sales

Under present law, a partner may be able to avoid recognition of gain on the sale of property to his partnership or another partner by characterizing the transaction as a contribution of the property followed by a distribution of cash or other property to the partner.

The bill provides that a transfer of property to a partnership and a related transfer to the contributing partner will be treated as occurring between the partnership and a person who is not a partner and thus will be treated as a sale. The provision applies to transfers after March 1, 1984.

d. Ordinary income property in tiered partnerships

Under present law, amounts received by a transferor partner in exchange for all or part of his partnership interest that are attributable to his interest in ordinary income assets of the partnership are treated as ordinary income. The rule can be avoided if ordinary income assets are held in a second partnership in which the distributing partnership holds an interest.

The bill treats a partnership that owns an interest in another partnership as owning its proportionate share of the ordinary income assets directly. A similar rule applies to interests in trusts. The provision applies to distributions, sales or exchanges after March 31, 1984.

e. Basis strips

Under present law, a partnership can elect to increase the basis of its assets by the amount of any basis that is "lost" when a distributee partner's basis in his interest is substituted for the basis of

distributed property. Thus, a partnership distributing high basis property to a low basis partner will experience an increase in the basis of its other property, but the distributee partner will lose basis and be exposed to greater gain if the distributed property is sold. This result can be avoided by contributing the high basis property to a lower tier partnership which has not elected to make basis adjustments, and by distributing the partnership interest to the low basis partner. The result is that the partnership property of the first partnership will experience a basis increase without reducing the basis of the contributed property.

The bill eliminates the elective basis adjustment for distributions of interests in partnerships that have not elected to make basis adjustments. The provision applies to distributions after March 1, 1984.

3. Like-kind exchanges of partnership interest

Under present law, like-kind exchanges of property held for productive use or investment are permitted to be made tax-free. These rules do not apply to inventory, stock, certificates of trust or beneficial interests, or other securities or evidences of indebtedness. In some cases, the courts have permitted tax-free like-kind exchanges of partnership interests. The Treasury has not acquiesced in these holdings.

The bill provides that tax-free like-kind exchange treatment is not available for exchanges of interest in different partnerships. The provision applies with respect to exchanges after March 31, 1984.

4. Transactions in mutual fund shares

Under present law, mutual fund distributions from capital gain income are taxed as long-term capital gain to shareholders even when made to a shareholder who has held the share for one year or less. If a shareholder who has held a share of a mutual fund for less than 31 days sells such share at a loss after a capital gain dividend has been received, the loss is treated as long-term rather than short-term to the extent of the capital gain dividend. Similar rules apply to real estate investment trusts.

Under the bill, losses on mutual fund stock held less than six months are treated as long-term losses to the extent of any capital gain dividends paid on the stock. There is an exception for periodic redemption plans. A similar rule is provided for real estate investment trusts. The provision applies to losses on shares of stock with respect to which the taxpayer's holding periods begin after the date of enactment.

5. Multiple trusts

Treasury regulations prevent grantors of trusts from reducing present taxation by establishing multiple trusts for the same beneficiaries which take advantage of the separate graduated rates applicable to each trust. A recent court decision held these regulations to be invalid. Under the bill, trusts established by substantially the same grantors for substantially the same beneficiaries with a principal purpose of tax avoidance would be consolidated for tax

purposes under Treasury regulations. The provision is generally effective for taxable years beginning after after March 1, 1984.

6. Trust distributions

Under present law, beneficiaries are taxed on amounts distributed from a trust (or estate) to the extent of the trust's (or estate's) distributable net income. The trust (or estate) is allowed a deduction for amounts taxed to its beneficiaries. Distributions of appreciated property are deemed to carry out distributable net income to the extent of the property's value at the time of distribution. The basis of the property in the hands of the beneficiary is its value to the extent it carries out distributable net income.

Under the bill, distributions of property carry out distributable net income only to the extent of the property's basis. Accordingly, the beneficiary's basis would be the same as the trust's (or estate's) and the appreciation would no longer be exempted from tax. Alternatively, the trust may elect to recognize gain on the distributed property. In such event, the consequences to the beneficiary would be determined under present law.

The provision applies to distributions after March 1, 1984.

C. Tax Treatment of Corporations and Their Shareholders

1. Dividends received by corporations

a. Debt financed portfolio stock

Under present law, when a corporation borrows the funds used to purchase dividend-paying stock, interest on the acquisition indebtedness is generally deductible against ordinary income. Dividends received by a corporation are eligible for an 85-percent dividend-received deduction. Thus, a corporation that borrows to finance purchases of portfolio stock effectively converts some ordinary income to dividend income, which is taxed at a maximum rate of 6.9 percent.

Under the bill, the dividends-received deduction is reduced by an amount determined by reference to interest paid or accrued on debt that is directly attributable to the investment in the underlying stock. The provision applies to leveraged stock, the holding period for which begins after the date of enactment.

b. Extraordinary dividends

Under present law, dividends received by a corporation generally have no effect on its basis in the stock of the distributing corporation. As a result, a corporation can buy stock for $100, receive a $15 extraordinary dividend on it, and then in short order sell the stock for $85. While some portion (generally 15 percent) of the $15 dividend will be taxed as ordinary income to the recipient corporation, the transaction, which has no economic consequences, will also generate $15 of short-term capital loss on the sale of the stock. This is an attractive transaction for corporations that have capital gains which can be sheltered by the loss on the sale of stock.

Under the bill, if a corporate shareholder does not hold stock for at least one year, the fair market value of any extraordinary dividend (to the extent not subject to tax) reduces its basis in the stock. Extraordinary dividends include dividends received within any 90-day period with a fair market value equal to or greater than 10 percent (five percent in the case of preferred stock) of the taxpayer's basis in the stock. This provision applies to distributions after March 1, 1984.

The holding period is limited to exclude, among other periods, any period during which the taxpayer is the grantor of a deep-in-the-money option with respect to the stock, or any period that the taxpayer's risk of loss is substantially diminished because of holding other positions. A similar rule is adopted for all purposes of the holding period rules applicable to the dividends received deduction. This holding period provision applies to positions acquired after the date of enactment. A corporate shareholder's holding period for property received as a dividend with respect to stock is limited so that it cannot exceed its holding period for such stock. This provi-

sion applies with respect to distributions declared after March 1, 1984.

c. Dividends from regulated investment companies

Under present law, a mutual fund, or regulated investment company (RIC), is not subject to Federal income tax if it distributes its income to its shareholders. If at least 75 percent of a RIC's gross income consists of dividends from domestic corporations, then the entire amount of the RIC's dividends to its shareholders is eligible for the 85-percent intercorporate dividends-received deduction. Taxpayers have organized RICs to take advantage of this tax provision that permits the conversion of interest income into dividend income.

Under the bill, the 75-percent rule of present law is raised to 100 percent for corporate shareholders with respect to eligibility for the dividends-received deduction. The provision applies with respect to taxable years beginning after the date of enactment.

d. Dividends-received deduction—compliance

Under present law, a broker who holds stock in street name for a customer may lend that stock to another customer for use in a short sale. The short-seller sells the borrowed stock with the expectation that the price of the stock will decline and expects to be able to purchase stock to return to the lending broker at a price below the proceeds of the sale. If a dividend is paid on the borrowed stock, the short-seller must pay the lender an amount in lieu of the dividend. The actual dividend is received by the purchaser in the short sale. If the borrowed stock belonged to a corporate client of the broker, the corporation is not entitled to the dividends-received deduction on the amount of the payment received in lieu of the dividend.

Under the bill, the broker reporting rules are amended to require brokers to provide a statement to corporate customers of amounts paid in lieu of dividends by reason of short sales. This provision applies to payments in lieu of dividends made after January 1, 1985.

2. Ordinary nonliquidating dividends of appreciated property

Generally, under present law, a distribution of appreciated property (such as interests in an oil and gas royalty trust) by a corporation with respect to its stock is not a taxable event to the distributing corporation.

Under the bill, in general, an ordinary nonliquidating distribution of appreciated property is taxable to the distributing corporation. Certain exceptions are provided. The provision applies with respect to distributions after the date of enactment with a transition rule.

3. Investment companies that accumulate earnings

Under present law, a corporation may deduct 85 percent of the dividends it receives on portfolio stock investments. Furthermore, gain on the sale of stock held by an individual for more than one year is generally taxed as long-term capital gains at rates not in excess of 20 percent. As a result, if a widely-held investment com-

pany invests in dividend-paying stocks and pays no dividends, its shareholders could hold the stock for at least a year and then sell it at a price that reflects dividends received and retained by the company. Their gains would generally be long-term capital gain, so individual shareholders would essentially be recognizing dividend income at a tax rate substantially below 50 percent. The company may take the position that it is not subject to the accumulated earnings tax because it is widely-held, an argument some courts have embraced in other contexts.

Under the bill, widely-held companies are not automatically excluded from the accumulated earnings tax.

Also, the net capital loss deduction is denied for mere investment or holding companies and amended, along with other provisions, for other companies. This provision applies with respect to taxable years beginning after the date of enactment.

4. Expenses incurred in connection with short sales

A short sale is a transaction in which the investor borrows stock, sells the stock, and later buys stock to repay the loan. Under present law, amounts paid by the taxpayer to the lender in lieu of dividends are deductible against ordinary income. A taxpayer can create short-term capital gain and ordinary loss by selling short before a dividend payment date and closing the short sale after the dividend date in a transaction with essentially no economic consequences.

Under the bill, in the case of a short sale of stock, payments in lieu of dividends are not deductible against ordinary income unless the short sale is held open for at least 16 days. No deduction is allowed for payments in lieu of extraordinary dividends unless the short sale is held open for at least one year. Amounts disallowed are treated as part of the basis of the short seller in the stock acquired to close the short sale. Amounts not disallowed as a deduction are treated as interest for certain Code purposes. The provision applies with respect to short sales after the date of enactment.

5. Transfers of partnership interests by corporations

Under present law, when a partnership interest is sold, any gain is ordinary income to the extent attributable to certain ordinary income items of the partnership. When a corporation distributes property, or sells property in the course of certain complete liquidations, recapture income is taxed to the corporation while non-recapture gain attributable to appreciation in the transferred property goes unrecognized. It has been argued that the corporate recapture provisions do not apply to the distribution or liquidating sale of an interest in a partnership that holds recapture property.

Under the bill, a corporate distribution or a liquidating sale of a partnership interest is treated as a transfer of the distributing corporation's allocable share of certain recapture items held by the partnership. The amount of income recognized is limited to the gain the corporation would have recognized had it sold the partnership interest. The provision applies to distributions after March 1, 1984.

6. Transactions involving foreign corporations

a. Certain transfers of appreciated property to foreign corporations

Under present law, certain transfers of appreciated assets to foreign corporations in reorganizations and liquidations, which would be tax-free, are taxable if the Internal Revenue Service rules that one of the principal purposes of the transfers was the avoidance of Federal income tax. Under Internal Revenue Service guidelines, generally, transfers of property used in the active conduct of a foreign trade or business are not taxed. However, also under those guidelines, transfers of assets containing built-in gain (such as inventory and accounts receivable) are generally taxed.

Judicial interpretation of the principal purpose test has reduced the ability of the Internal Revenue Service to administer section 367. In addition, the Internal Revenue Service's current ruling policy permits the tax-free transfer of intangible property abroad, where the development of the property generated significant U.S. tax benefits but the income derived from the property may escape U.S. taxation. Finally, the courts have rejected the Internal Revenue Service's requirement that certain losses be recaptured upon the incorporation of a foreign branch by a U.S. person.

Under the bill, the rules governing transfers of appreciated property abroad are amended to provide for gain recognition without regard to purpose, unless the property is transferred for use in an active trade or business abroad. Certain transfers of assets containing built-in gain are automatically subject to tax. Transfers of stock are subject to the active trade of business test. In addition, transfers of intangibles for less than full consideration are subject to tax. Full consideration includes an arm's length royalty. The intangibles rule does not apply to goodwill or going concern value developed by a foreign branch. Finally, the current Internal Revenue Service policy on incorporations of foreign branches is codified. The provision applies to transfers after January 1, 1985.

b. Decontrol of foreign corporations

Under present law, when a U.S. taxpayer who is a 10-percent shareholder of a controlled foreign corporation sells or exchanges stock in a taxable transaction, the gain is treated as ordinary (dividend) income to the extent of the shareholder's pro rata share of the corporation's post-1962 accumulated earnings and profits. A U.S. corporation that disposes of stock by distributing it as a dividend-in-kind or in the course of liquidation, in a transaction eligible for nonrecognition treatment to the U.S. corporation, is also required to include in income its share of post-1962 accumulated earnings and profits. Taxpayers have taken the position that section 1248 does not apply if a controlled foreign corporation that is wholly owned by a U.S. corporation issues new shares for shares of the U.S. corporation. If this position were sustained, such a transaction could lead to permanent exemption from U.S. corporate tax of the earnings of the controlled foreign corporation accumulated prior to the exchange.

Under the bill, certain exchanges by a controlled foreign corporation of its newly issued stock for shares of its U.S. parent corpora-

tion are treated as sales or exchanges by the U.S. parent of stock in the controlled foreign corporation. The provision applies as of the date of enactment.

c. Recharacterization of U.S. income as foreign income

Under present law, the United States taxes the U.S. income of U.S. taxpayers. U.S. taxpayers' foreign income can be free of U.S. tax under the foreign tax credit. U.S. taxpayers can place the foreign label on some U.S. income (such as interest and insurance premiums) by routing it through a foreign corporation. This foreign corporation distributes foreign dividends to its U.S. owners. This newly foreign income may escape U.S. (and foreign) tax.

The bill prevents relabeling of U.S. income as foreign income. Under the bill, if a corporation, 10 percent (or more) of whose gross income is U.S. income (including U.S. business income), pays interest or dividends to a U.S. taxpayer, a pro rata portion of the payment is U.S. income. Thus, if 75 percent of a corporation's gross income is U.S. income (over a three-year period), 75 percent of the dividends and interest it pays is U.S. income. The bill applies only to 50-percent U.S-owned corporations. Generally, it applies with respect to income earned by paying corporations after the date of enactment.

d. Recharacterization of interest income as dividend income

Under present law, a U.S. taxpayer's foreign interest income cannot escape both U.S. and foreign tax (under the United States' separate foreign tax credit limitation that prevents foreign taxes on non-interest income from offsetting U.S. tax on foreign interest income). U.S. taxpayers seek to circumvent this rule by creating foreign subsidiaries to earn foreign interest income (for example, by depositing money in foreign banks). When the U.S. taxpayer is taxable on the earnings of its foreign subsidiary, its income is dividend income, not interest income. Thus, newly recharacterized "non-interest" income may totally escape both U.S. and foreign tax.

The bill treats foreign dividends as interest to the extent that the paying corporation's earnings and profits arise from interest. This rule applies only if 10 percent or more of the paying corporation's earnings and profits for the three taxable years preceding the taxable year in which the dividend is paid arise from interest. The provision generally applies to income earned by paying corporations after the date of enactment.

e. Use of territories to avoid U.S. tax

Under present law, payments of U.S. source interest, dividends, and other passive income to foreign investors are generally subject to a 30-percent U.S. withholding tax. The United States does not tax payments of passive income to corporations organized in Guam, the Northern Mariana Islands, or the U.S. Virgin Islands. Some argue that foreigners who wish to invest in the United States may avoid both U.S. and territorial tax by channeling their investments through conduit corporations in these territories.

Temporary Treasury regulations subject dividends and interest paid by territorial conduit corporations to territorial withholding tax. Guam is contesting these regulations in court.

Under the bill, interest, dividends, and other passive income paid from U.S. sources to corporations organized in Guam, the Marianas, or the Virgin Islands are subject to U.S. tax unless the bulk of the recipient's gross income is from territories and unless the bulk of its beneficial owners are local residents. The provision applies with respect to payments made after March 1, 1984.

f. Source of transportation income

Under present law, in general, the United States taxes all U.S. income, but not all foreign income, of United States persons. In general, the United States does not tax the foreign income of foreign persons (such as foreign corporations). Under present law, transportation income can be almost all foreign even if the transportation is between two U.S. points, if the route of transport lies primarily outside the United States' three mile territorial limit.

Under the bill, income earned from transportation that begins and ends in the United States (or U.S. possessions) is treated as U.S. income. Income earned from transportation includes services income and leasing income from ships, airplanes, and containers used in connection with ships and airplanes. The effective date is the date of enactment.

g. Foreign collapsible corporations

Under present law, sales of inventory yield ordinary income, not capital gain. "Collapsible" corporations' assets generally include inventory. Generally, a shareholder's gain on the sale or liquidation of a collapsible corporation is ordinary income rather than capital gain. However, if a collapsible corporation consents under section 341(f) to recognize ordinary income on disposition of its inventory and the like, the shareholder gets capital gain treatment on the sale or liquidation of the corporation. In the case of a consenting foreign corporation, enforcement of the consent may be impractical.

Under the bill, to the extent provided in regulations, foreign corporations are ineligible to make consents under section 341(f). The effective date is the date of enactment.

7. Transactions in stock warrants

Present law is unclear as to the tax consequences of a corporation's dealing in its own warrants. Under present law, taxpayers with a gain may take the position that no gain is recognized and taxpayers with a loss may report the loss.

Under the bill, no gain or loss is recognized by a corporation on any transaction with respect to a warrant to buy or sell its own stock. The provision applies with respect to warrants acquired or lapsing after the date of enactment.

8. Exchange of debt for stock

Under present law, a corporation recognizes gain when it buys back its debt at less than par value. The gain may be deferred. However, a corporation does not recognize gain when the debt is

repurchased by issuing its own stock. Thus a corporation is treated differently where it raises cash to discharge its debts by issuing new stock and where it discharges the debt by issuing stock directly.

The bill provides that the scope of the "stock for debt" exception is limited to insolvent corporations or corporations under title 11 (bankruptcy law). The provision applies to transfers after the date of enactment.

9. Distribution of debt by a corporation

Under present law, earnings and profits of a corporation are reduced by the principal amount of its obligations distributed to shareholders. Generally, for noncorporate shareholders, the amount of a distribution taken into account is the fair market value of the property distributed. A long-term obligation bearing little or no stated interest will have a present fair market value well below its stated redemption price. The result may be to eliminate corporate earnings and profits at the cost of a relatively small dividend to shareholders.

The bill amends the earnings and profit rules to limit the reduction in earnings and profits resulting from the distribution of the corporation's own debt obligations. Also, under the bill, these obligations are subject to the original issue discount rules. This provision applies with respect to distributions made after the date of enactment.

10. Definition of affiliated group of corporations

Under present law, an affiliated group of corporations is permitted to file a consolidated return. For certain tax rules, an affiliated group of corporations is treated as a single corporation. Affiliation may be achieved even though convertible preferred stock, or convertible common stock with a very small vote, with a significant equity value is owned by outsiders.

The committee bill amends the definition of "affiliated group" (sec. 1504(a)) to require 80 percent of the equity as well as 80 percent of the voting power in order to consolidate. Rules relating to deconsolidation are also provided. The provision applies with respect to taxable years beginning after December 31, 1984. Transitional rules are provided.

11. Net operating losses

Provisions from the Tax Reform Act of 1976 relating to special limitations on the carryover of net operating losses and other tax attributes are scheduled to become effective at varying times during 1984.

The bill delays the effective date of those provisions through October 31, 1984. As a result, the rules in effect prior to 1984 remain in effect.

D. Time Value of Money and Other Accounting Provisions

1. Deferred payment transactions

a. Time for inclusion or deduction of deferred interest

Present law provides that, in general, in a discount lending transaction, the borrower is treated as having paid, and the lender as having received, the annual unpaid interest, which is then relent to the borrower. These original issue discount (OID) rules match the interest inclusion by the lender with the interest deduction by the borrower. The OID rules of present law do not apply to obligations issued in exchange for property where neither the obligation nor the property is publicly traded; to obligations issued by individuals; as to holders of discount obligations, to obligations not held as capital assets; or to deferred payments for services or use of property.

The bill extends the OID rules to obligations issued for nontraded property, issued for services or use of property, issued by individuals, and not held as capital assets. The interest element in obligations issued for nontraded property, services, or use of property is to be compared to a test rate. The test (safe harbor) rate is 110 percent of an average yield on Federal obligations of similar maturity (the "applicable Federal rate"). This yield is to be redetermined semi-annually for 3 categories of maturities (short-, medium-, and long-term). If interest is not paid annually at least at this rate (or if interest stated at a higher rate is not paid at least at that rate), interest is to be imputed at a rate equal to 120 percent of the applicable Federal rate (or at the higher stated rate) and annually included in the income of the lender and deducted by the borrower. Exceptions to these rules are provided for sales of principal residences, certain sales of farms, and sales involving total payments of $250,000 or less. These provisions generally apply to transactions entered into after December 31, 1984.

Foreign investors acquiring pure original issue discount corporate bonds—those with no payment of interest until maturity—defer U.S. taxation until they surrender the bonds at maturity. The rules governing timing of income inclusion for foreign investors holding corporate OID debt differ in some respects from those governing income inclusion for U.S. investors. As for foreign holders of debt originally issued at a discount by obligors other than corporations and governmental entities, existing law is unclear.

The bill conforms the timing of income inclusions for foreign investors to the timing for comparable U.S. investors, except that there is no inclusion for foreign investors until actual receipt of payment. The bill also conforms the treatment of non-corporate debt to the treatment of corporate debt. These provisions generally apply to payments made on or after the 60th day after the date of enactment.

The Internal Revenue Code does not contain specific rules governing foreign investors who sell or surrender stripped bonds or who sell stripped coupons. The bill generally conforms the rules governing foreign investors to those governing U.S. investors, except that there is no inclusion for foreign investors until actual receipt of payment. Thus, foreign investors will treat stripped coupons and stripped bonds as being OID instruments. These provisions will apply generally to payments made on or after the 60th day after enactment.

b. Measurement of interest in deferred payment transactions

Under present law, if the parties to a deferred payment sale fail to state interest at a safe-harbor rate fixed by regulation, interest is imputed at a higher rate fixed by regulation. The safe-harbor rate is a simple interest rate; the imputed rate is a compound rate. Imputed interest is allocated among deferred payments in proportion to the amount of the payment, without regard to the period of time that has elasped since the sale.

The bill provides that the adequacy of the interest element in a deferred payment sale is to be tested against a self-adjusting compound rate of interest which approximates a market rate. This test (safe-harbor) rate is the same rate applied under the proposed amendments to the OID rules: 110 percent of the applicable Federal rate. If insufficient interest is stated, interest is to be imputed at a rate equal to 120 percent of the applicable Federal rate. Interest income will be recognized by the lender and interest expense will be deducted by the borrower on an economic accrual basis according to the taxpayer's normal method of accounting.

The bill generally applies to sales or exchanges after December 31, 1984; except for sales or exchanges with respect to which there was a binding commitment on March 1, 1984. However, as to any transactions entered into after March 1, 1984, and before January 1, 1985, the bill provides that a deduction will not be allowed for interest in excess of the amount properly allocable to the period.

2. Premature accruals

Under the accrual method of accounting, an expense is deductible when all events have occurred which establish the fact of liability and the amount of the liability can be determined with reasonable accuracy. The proper time for deducting expenses for which economic performance has not yet occurred is the subject of controversy under present law.

The bill generally requires that economic performance must occur before all events establishing the fact of liability will be considered to have occurred.

Exceptions are made for items for which specific timing rules are already provided under the Code, such as bad debts and vacation pay. The bill also provides a 10-year carryback for losses arising from certain deferred liabilities and a longer period for certain losses associated with the decommissioning of nuclear generating plants.

The bill applies to expenses accruing after the date of enactment.

3. Prepaid expenses

Except with respect to interest and prepayments by farm syndicates, present law is unclear as to the proper timing of a deduction for prepaid items by cash method taxpayers. In the case of interest, deductions are allowed only for the year to which the interest relates. A similar rule applies to prepaid expenses of farm syndicates.

Under the bill, tax shelter organizations will not be permitted to deduct any amount prior to the time it would be properly deductible under the accrual method of accounting. The bill defines tax shelter organizations to include certain partnerships and enterprises, and any entity, plan or arrangement having the principal purpose of tax avoidance. This rule will apply to prepayments made after the date of enactment.

4. Deferred like-kind exchanges

Under present law, no gain or loss is recognized on the exchange of business or investment property for property of a like-kind. An intended like-kind exchange transaction may be held open for as much as five years under the case law. The bill provides that property received more than 180 days after the taxpayer transfers the relinquished property (or if earlier, after the due date of the taxpayer's return) will not be treated as like-kind property. This provision will apply to transfers of property made after the date of enactment (or closed after 1986).

5. LIFO conformity

Currently, the "Last-In First-Out" (LIFO) method of inventory accounting may not be used for tax purposes unless it is also used in reporting to shareholders, partners, other proprietors, beneficiaries, or for credit purposes. An issue has arisen as to whether a parent company is subject to these LIFO conformity rules when the inventory is held by a subsidiary company. The bill makes the LIFO conformity requirement applicable to financially-related corporations as if they were a single taxpayer, effective for taxable years beginning after the date of enactment.

6. Inclusion of tax benefit items

Under present law, an individual taxpayer who receives a State tax refund may exclude from income an amount equal to the excess of the zero bracket amount over the taxpayer's other itemized deductions for the year in which the State taxes were deducted. This exclusion is permitted even though the deduction of this amount in the prior year resulted in a tax benefit.

The bill provides that where a taxpayer recovers a previously-deducted amount, the recovered amount is excluded from gross income only to the extent such amount did not reduce income subject to tax. The bill also requires an increase in tax for any year in which an amount relating to a credit claimed in a prior year is recovered, except to the extent that the credit did not reduce the amount of tax. This provision will not apply to amounts recovered relating to foreign tax credits and investment tax credits, the treatment of which is governed by existing law. This provision will apply to amounts recovered after December 31, 1983.

7. Low-interest and interest-free loans

Under present law, loans between family members generally result in taxable gifts in an amount equal to the value of the interest that is not charged. No income tax consequences result, however, to either the lender or the borrower. Loans by corporations to their shareholders, and loans to persons providing services by persons for whom the services are provided generally do not have any Federal tax consequences.

Under the bill, low-interest and interest-free loans generally are to be recharacterized as (1) a loan to the borrower at a statutory interest rate, and (2) either a gift (in the case of a family transaction), dividend (in a corporation-shareholder transaction), compensation (in a transaction involving services) or some other payment in accordance with the substance of the transaction. The borrower is treated as paying interest on the loan at the statutory rate, resulting in income to the lender and a deduction to the borrower. An exception is provided for non-tax motivated transactions. This provision is effective on March 1, 1984, except with respect to demand loans repaid within 60 days of the date of enactment.

8. Income averaging

Income averaging is presently available to taxpayers with "averageable income". Averageable income is current year taxable income in excess of 120 percent of average taxable income in the four preceding years. In effect, income averaging widens the tax brackets by a factor of five with respect to averageable income.

The bill increases the 120-percent requirement to 140 percent and provides that only the three preceding years are to be taken into account. The bill modifies income averaging so that it, in effect, widens the tax brackets by a factor of four, not five, with respect to averageable income.

These changes are effective for taxable years beginning after December 31, 1983.

E. Treatment of Bonds and Other Debt Instruments

1. Debt obligations acquired at a discount

a. Market discount

Under present law, upon the disposition of a market-discount bond issued by a corporation or a governmental unit and held for more than one year, capital gain treatment is accorded to the appreciation in value attributable to market discount. When a taxpayer borrows the funds used to purchase a market-discount bond, interest on the acquisition indebtedness generally can be deducted currently against ordinary income. Thus, a taxpayer who leverages the purchase of a market-discount bond effectively converts ordinary income to capital gain.

The bill generally requires that gain on disposition of a market discount bond be recognized as interest income, to the extent of accrued market discount (computed under a linear formula). This provision is effective for bonds issued after the date of enactment.

The bill also limits a taxpayer's ability to take current interest discount deductions on indebtedness incurred to purchase or carry a market bond. This change is effective for bonds acquired after the date of enactment.

The bill provides an election to include accrued market discount in income currently. Neither the rule requiring ordinary income treatment on disposition nor the rule limiting interest deductions will apply to bonds with respect to which the election is made.

b. Original issue discount on tax-exempt bonds

Under the Code, original issue discount (OID) on noninterest-bearing obligations issued by a State or local government is exempt from tax. Under Internal Revenue Service rulings, tax-exempt OID is apportioned on a straight-line basis among the original holder and subsequent purchasers of a bond. The application of this rule permits the holder of a deep discount municipal bond to generate an artificial loss by disposing of the bond prior to maturity.

The bill requires the holders of tax-exempt obligations to accrue tax-exempt OID by using the constant interest method provided by present law for the holders of obligations issued by corporations and other entities. Under the bill, the basis of an obligation is increased by the amount of accrued tax-exempt OID. Thus, the holder of a zero coupon municipal bond will be able to claim economic losses realized on disposition of the bond. These changes apply to bonds issued after September 3, 1982, and acquired after March 1, 1984.

c. Discount on short-term obligations

For governmental obligations (Treasury bills) issued at a discount and payable without interest at a fixed maturity not exceeding one

year, the acquisition discount is not considered under present law to accrue until the obligation is paid at maturity or otherwise disposed of. A similar rule applies with respect to original issue discount of cash-basis taxpayers who hold other obligations with a maturity of one year or less (e.g., bank certificates of deposit). Taxpayers who make leveraged purchases of obligations eligible for the special rules are able to defer tax liability on unrelated income.

The bill limits the scope of the special rules permitting deferral of acquisition and original issue discount on short-term obligations. Accrual basis taxpayers and those cash basis taxpayers who acquire Treasury bills and short-term orginal discount obligations in the course of a trade or business will be required to account for the acquisition or original issue discount on the accrual basis. Taxpayers will treat this change as a change of accounting method and space the payment of any net tax liability over 10 years. In addition the bill limits the ability to use leveraged purchases of short-term obligations within the special rules to defer tax on ordinary income by deferring the deductions for interest on indebtedness used to purchase or carry short-term discounts obligations. An election is provided under which taxpayers who remain eligible for the special rules can avoid application of the interest deferral rule by electing to include acquisition and original issue discount in income as it accrues.

This provision will be effective for obligations acquired after the date of enactment.

2. Factoring trade receivables

Under present law, a seller who sells goods for the buyer's receivable (a transferable debt) may sell that receivable to a third party—a factor—at a discount. If a U.S.-owned factor is in a tax haven, it may earn income free of U.S. tax. That income may be eligible for deferral, and it may be foreign-source income that is sheltered by excess foreign tax credits. Further, when a foreign subsidiary of a U.S. corporation invests in U.S. property, that investment is taxable as a dividend to the U.S. parent. Some taxpayers allege that this rule does not apply to a foreign factoring subsidiary that buys receivables from its U.S. parent.

Under the bill, when a foreign factoring subsidiary of a U.S. owner gets cash for a receivable that (1) it bought from a related person, and (2) the related person had taken in exchange for inventory, the U.S. owner is taxed on that factoring income. The bill treats income from a related U.S. person's receivables as U.S. income. The bill also treats payments of cash from a foreign subsidiary to a related U.S. person for receivables arising from the U.S. person's sales of inventory as investments in U.S. property. Thus, payments of cash for receivables will be taxable as dividends to the U.S. parent. This provision will apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984 in taxable years ending after that date.

F. Compliance Provisions

1. Promoter's customer lists

Present law does not require promoters of potentially abusive tax shelters to keep customer lists available to the Internal Revenue Service. The bill requires promoters of investments having a potential for tax avoidance or evasion to maintain customer lists in the manner provided by Treasury regulations. The bill provides a $50 penalty per failure to list a customer, up to $50,000 per year. This provision is effective on the date of enactment.

2. Promoter's penalty

The Tax Equity and Fiscal Responsibility Act of 1982 provides for a penalty on promoters of abusive tax shelters equal to the greater of $1,000 or 10 percent of income from the activity. The bill increases the 10-percent penalty to 20 percent, effective the day after the date of enactment.

3. Practice of appraisers

The Treasury Department presently has no authority to prevent disreputable appraisers from providing appraisals for use on tax returns or from appearing in proceedings before the Treasury Department. The bill provides that the Treasury Department may bar appraisers who aid or assist in the preparation of false returns or other documents from practice before it. This provision will be effective on the date of enactment.

4. Foreclosure reporting

Under present law, foreclosures in satisfaction of a debt or forgiveness of a debt may give rise to income to the debtor which may be treated as ordinary income under the recapture rules. The bill requires persons lending in the course of a trade or business to report to the Internal Revenue Service, except in the case of consumer loans, when a debt of $15,000 or more is satisfied in full or in part by a foreclosure, an acquisition of property, or an abandonment of security for a loan. The bill generally provides for a $50 penalty per failure to comply. This provision will apply to foreclosures, acquisitions of property and abandonments of security for a loan taking place after December 31, 1984.

5. Mortgage interest reporting

No informational reports are required under present law with respect to amounts deductible by individual taxpayers who itemize their deductions. The bill requires persons (including governmental units) who receive mortgage interest payments in the course of a trade or business to report annually to the Internal Revenue Service the amount of the interest, and the person from whom the pay-

ment is received. The payor must be provided a copy of the report. Payments aggregating less than $600 are exempt. The bill generally provides for a $50 penalty per failure to comply. This provision will apply to payments after December 31, 1984.

6. Disposition of partnership interests

When a partnership interest is sold or exchanged, the transferred partner may have reportable gain or loss under present law. In addition, if the value received is attributable to appreciated inventory or unrealized receivables that could produce ordinary income if sold by the partnership, the transferor will be treated as having realized ordinary income. The bill requires a partnership to inform the Internal Revenue Service, the seller and the buyer of the fair market value of the allocable share of unrealized receivables and inventory when partnership interests are sold or exchanged. A $50 penalty generally is imposed for each failure to comply. This provision will apply to sales and exchanges made after December 31, 1984.

7. IRA reporting

Present law generally allows an individual to deduct the amount of qualified individual retirement account (IRA) contributions made for a year, either during the year or before the due date of the income tax return for the year. In the absence of reporting by the trustee or issuer, the Internal Revenue Service has difficulty verifying whether contributions were made and the year to which they relate. The bill clarifies the authority of the Treasury Deparment to require reporting on contributions to IRAs by the trustee or issuer. Reports are to include the amount and the year to which a contribution relates. The bill generally provides for a $50 penalty per failure to comply. This provision will apply to contributions made after April 15, 1984, and relating to 1984 and subsequent years.

8. Reporting of State income tax refunds

State and local governments are required under present law, to provide information to the Internal Revenue Service on refunds of State or local income tax, and to supply a copy to the taxpayer in January of the following year. Under temporary regulations, the Treasury Department has provided that reporting is not required when the officer making the refund determines that the individual received no Federal tax benefit from the tax payment to which the refund relates. The bill codifies the provisions of the temporary regulations providing exceptions from the reporting requirement. This provision of the bill applies to refunds, credits, and offsets allowed after December 31, 1982.

G. Employer-Employee Benefit Provisions

1. Deductions for contributions to funded benefit plans

The bill provides new rules for determining the timing and the amount of an employer's deduction for a contribution to a funded welfare benefit plan. Under the bill, a contribution which is otherwise deductible under the Code generally will be deductible only to the extent that it does not exceed the amount a cash-basis employer could deduct under a unfunded arrangement, plus an addition to a funded reserve generally permitted to equal 75 percent of average benefit costs. This provision will apply to employer contributions made after March 31, 1984, to funded welfare benefit plans. A delayed effective date is provided for the welfare benefit plans of collective bargaining units.

2. Additional requirements for tax-exempt status of VEBA

The bill provides that an association that is otherwise exempt from tax as a voluntary employees' beneficiary association (VEBA) will not be tax exempt unless it meets new standards provided by the bill. These standards provide more effective rules prohibiting discrimination in favor of highly compensated employees, and limit the portion of a benefit that may be used by highly compensated employees. Under the bill, the rules aggregating employees of related employers for purposes of testing qualified pension plans will apply (with modification) in testing VEBAs. These new nondiscrimination standards do not apply to a VEBA maintained pursuant to a collective bargaining agreement.

3. Tax on unrelated business income

Present law imposes a tax on the unrelated business income of a tax-exempt organization. In the case of a voluntary employees' beneficiary association (VEBA) or a supplemental unemployment compensation benefit trust (SUB), the tax is imposed on income not set aside for the exempt purpose of the association. Present law, however, does not establish clear limits on the amount that may be set aside.

Under the bill, the amount set aside is not to exceed the level of the qualified asset account determined under the rules relating to deductions for contributions to the VEBA or SUB.

4. Unfunded deferred benefits

Under present law, the tax treatment of an employer with respect to employee benefits may depend upon whether the benefit is deferred compensation or a welfare benefit. Present law does not clearly distinguish between these two types of benefits. The bill clarifies the distinction between welfare benefits and deferred com-

pensation. The provision applies to amounts paid or accrued after March 31, 1984.

5. Retirement plans for airline pilots

Present law imposes limits on contributions and benefits under tax-qualified plans. Under these limits, the annual benefit payable under a defined benefit plan generally cannot exceed $90,000 for 1984. The $90,000 limit is reduced if a benefit is payable before age 62. Under the bill, in the case of commercial airline pilots who are required, under Federal regulations, to retire at age 60, the limits on benefits under qualified defined benefit pension plans will not be reduced for early retirement at age 60.

6. Treatment of certain medical, etc., benefits

In applying the overall limits on contributions and benefits under qualified plans, the bill provides that any contributions allocated to an individual medical benefit account of an employee under a qualified defined benefit plan is to be treated as an annual addition under a qualified defined contribution plan. Accordingly, the amount allocated for a year will be included, together with employer contributions and reallocated forfeitures, in determining whether the defined benefit plan and any defined contribution plan of the employer meet the separate limits and the combined limits provided with respect to such plans.

7. Accrual of vacation pay

Present law generally limits the accrual of vacation pay on the basis of vacation pay earned by the end of the year and payable before the close of the succeeding year. The bill limits the accrual of vacation pay on the basis of vacation pay earned by the end of the year and reasonably expected to be paid before the close of the succeeding year. This provision applies to taxable years beginning after March 31, 1984.

8. Treatment of gain on property transferred from employer and employee benefit associations

Under present law, special rules deny capital gain treatment in transactions between related parties. Present law, however does not treat an employer and an exempt organization controlled by the employer as related parties. Under the bill, certain exempt organizations will be treated as related parties with respect to an employer under the rules of the Code treating gain on certain transactions as ordinary income.

9. Discrimination rules for cash-or-deferred arrangements

Under present law, an employee may elect to defer compensation (within limits) under a qualified cash-or-deferred arrangement that is provided by a tax-qualified profit-sharing or stock bonus plan. Permitted deferrals are generally not taxed until they are distributed. In determining whether a cash-or-deferred arrangement meets the nondiscrimination standard of the Code for qualified plans, either a special nondiscrimination standard for cash-or-deferred arrangements or the general nondiscrimination standard may be applied.

Under the bill, a cash-or-deferred arrangement will be a qualified cash-or-deferred arrangement only if it meets the special tests provided by the Code relating to average deferral percentages. The failure of a cash-or-deferred arrangement to meet the special tests will not result in the disqualification of a plan if the plan meets the usual requirements for qualification. This provision is effective for amounts paid or incurred after March 31, 1984.

10. Determination of whether there is a collective bargaining agreement

Under present law, special rules relating to employee benefits apply with respect to collectively bargained plans. Some of these rules provide effective dates that are more appropriate for these plans. In other cases, rules forbidding discrimination in favor of highly compensated employees are modified or waived with respect to employees included in a collective bargaining unit.

The bill clarifies present law by providing that, in determining whether there is a collective bargaining agreement between employee representatives and one or more employers, an organization is not to be considered an employee representative if more than one-half of its members are employees (including a self-employed individual who is considered to be an employee under the rules for qualified pension plans) who are owners, officers, or executives of the employer. This provision is effective on April 1, 1984.

H. Other Provisions Affecting Certain Tax-Motivated Transactions

1. Transfers of depreciable property between related taxpayers

Present law provides that a transferor will be treated as receiving ordinary income rather than capital gain on the transfer of property to a related party when that property is depreciable property in the hands of the transferee. The courts have held that the transfer of a patent application as opposed to a patent does not fall within this anti-abuse rule because the application itself is not depreciable property. However, once the application is granted, the transferee can depreciate the resulting patent.

The bill amends the present law rules to treat a patent application as depreciable property, thus requiring that any gain recognized to the transferee be treated as ordinary income rather than capital gain. The bill broadens the rule to cover, generally, sales between a taxpayer and a trust in which the taxpayer or the taxpayer's spouse have a beneficial interest. This provision applies to transfers made after March 1, 1984.

2. Collapsible corporations

Under present law, a collapsible corporation, generally, is one formed or availed of principally for the manufacture, construction, production, or purchase of certain types of property with the view to the sale or exchange by the shareholders of their stock (or of the liquidation of the corporation) before the realization by the corporation of a "substantial" part of the taxable income to be derived from such property. If stock in a collapsible corporation is sold, exchanged, or the corporation is liquidated in whole or in part (i.e., collapsed), or in the case of certain distributions, any gain recognized by any shareholder in any such sale, exchange, liquidation, or distribution which would otherwise be long-term capital gain, is considered ordinary income.

Under court decisions a corporation will have realized a "substantial" part of the taxable income to be derived from the property if the corporation realizes as little as one-third of the taxable income to be derived from the property. Present law also provides an exception to collapsible corporation treatment (the "70/30" rule). In general, under this rule, if 70 percent or less of a shareholder's total gain in a taxable year is attributable to collapsible assets of the corporation, then none of the recognized gain in such year is treated as ordinary income.

Under the bill, the substantial part required is defined as two-thirds of the taxable income to be derived from the property. Conforming changes are made to the "70/30" rule to prevent corporations from otherwise avoiding the collapsible corporation provision. These changes are effective on the date of enactment.

3. Excise tax payments to Puerto Rico and the U.S. Virgin Islands

Under present law, a special excise tax is imposed on certain articles coming into the United States from Puerto Rico and the U.S. Virgin Islands. Revenues from the special tax are paid to the governments of Puerto Rico and the U.S. Virgin Islands. Puerto Rico presently conducts a program under which distilled spirits from the United States are redistilled in Puerto Rico and reshipped to the United States, thereby enabling Puerto Rico to receive an excise tax payment.

Under the bill, revenues from excise tax on articles coming into the United States from Puerto Rico and the U.S. Virgin Islands will be paid to those possessions only (1) in the case of distilled spirits, if at least 90 percent of the distilled spirits were originally distilled in Puerto Rico or the U.S. Virgin Islands; (2) in the case of any article subject to Federal excise tax which comes into the United States from Puerto Rico, if 50 percent or more of the value of the article is attributable to Puerto Rican input; and (3) in the case of any article subject to Federal excise tax, if the applicable possession provides no subsidy to the industry involved of a kind different from that provided to industry generally. A general exemption is provided for rum; a limited exception from (2) and (3) is provided for cane neutral spirits meeting test (1).

This provision of the bill generally will apply to articles coming into the United States after February 29, 1984. However, a transition rule permits payments of $130 million of tax with respect to redistilled spirits between July 1, 1983 and June 30, 1984; this amount is reduced to $75 million for the period July 1, 1984 through June 30, 1985.

I. Straddles and Other Securities

Under present law, several special rules apply to limit tax benefits from straddle transactions. Under the loss deferral rule, losses on straddles are deferred to the extent of gains on offsetting positions. However, there is an exception from this rule for straddles involving stock and stock options. Also, a mark-to-market system applies to regulated futures contracts under which taxes are paid on unrecognized gains and losses at the end of each year. Under the mark-to-market rules, gains and losses are treated as 60-percent long-term and 40-percent short-term, providing a maximum tax rate of 32 percent. The tax treatment of options on futures contracts and cash settlement options is unclear under present law.

The bill repeals the exception from the loss deferral rule for stock options and substitutes a limited exception applying to covered calls which are not deep-in-the-money. The exception from the straddle rules for stock would only apply where both legs of the straddle consist of positions in stock. When a taxpayer has written an in-the-money covered call, any long-term gain on the sale of the stock will be recharacterized as short-term to the extent of any short-term losses on the option.

The bill also extends the mark-to-market system to options on futures contracts, to options where the underlying property is not equity based, to options on broad-based equity indexes, and to options held by options market makers.

The bill modifies the hedging exception to the anti-straddle rules to reduce the possibility that it may be used to generate losses that shelter unrelated income from tax.

The Treasury Department's authority to issue regulations with regard to the straddles rules is extended so that it can deal with the problems presented under present law by mixed straddles.

The bill clarifies the treatment of cash settlement options.

The repeal of the exception for stock options from the anti-straddle rules is effective for positions entered into after October 31, 1983. The extension of mark-to-market rules is effective for positions entered into after the date of enactment. Transition rules are provided similar to those which were provided when the mark-to-market system for regulating futures contracts was implemented in 1981.

J. Highway Use and Diesel Fuel Taxes

1. Heavy vehicle use tax

Under present law, the highway use tax is scheduled to increase beginning July 1, 1984, reaching a maximum rate of $1,900 per year on the heaviest vehicles by July 1, 1988. The bill restructures the use tax to eliminate tax on vehicles under 55,000 pounds and provides a maximum tax rate of $500 per year, effective July 1, 1984. Rules applicable to small owner-operators are amended, effective July 1, 1984. The Department of Transportation is instructed to study improvements in the application of the use tax to vehicles over 80,000 pounds.

2. Diesel fuel tax

The bill increases the excise tax on diesel fuel sold for use in highway vehicles by 5.5 cents per gallon to 14.5 cents per gallon. In addition, original owners of recent model year diesel vehicles (having a gross vehicle weight under 10,000 pounds) and purchasers of new diesel vehicles (having a gross vehicle weight under 10,000 pounds) receive a one-time tax credit reflecting the amount of extra diesel fuel taxes expected to be paid over the normal useful life of the vehicle. This provision is effective on July 1, 1984, for vehicles purchased before January 1, 1988.

K. Other Miscellaneous Provisions

1. Extension of PIK rules to 1984 wheat program

Present law provides special tax treatment for commodities received by a producer under a 1983 PIK program for withdrawing land from production. Under these rules, producers may defer recognition of income on PIK commodities until the commodities are sold; PIK participants are not disqualified from various special tax provisions available to taxpayers engaged in the business of farming; and the applicability of other income, employment, and estate tax provisions is not affected solely as a result of a taxpayer's participation in the PIK program. The bill generally extends these special PIK tax rules to the 1984 wheat program.

2. Unemployment compensation for pre-1978 periods

The bill amends the Revenue Act of 1978 to provide that the provisions of that statute which make includible in income a portion of unemployment compensation benefits apply to payments of unemployment compensation made after 1978 except payments for weeks of unemployment ending before December 1, 1978. The bill also extends until one year after enactment the period for claiming any credit or refund attributable to this amendment.

3. Traveling expenses at Nekoma ABM site

Under the bill, traveling expenses in connection with employment at the Nekoma, North Dakota, antiballistic missile project are deductible if (1) the expenses are otherwise deductible as business expenses; (2) the expenses were paid or incurred after 1969 and before 1975; and (3) the expenses were claimed on a tax return filed for any taxable year which includes any portion of the period described in (2). In addition, the bill extends the period of limitations for obtaining refunds due as a result of the provisions of the bill.

4. Limitation on depreciation and investment tax credit for luxury automobiles

Present law allows an investment tax credit and cost recovery deductions on the cost of an automobile used for a business or income-producing purpose. The bill limits the investment credit and cost recovery deductions to the first $21,000 of cost, effective for automobiles placed in service after March 1, 1984. Also, it institutes a rebuttable presumption that business use of any car does not exceed 50 percent, effective in taxable years beginning after 1984.

5. Investment income from S corporations

Under present law, an individual's deduction for investment interest is generally limited to the taxpayer's net investment income plus $10,000. The bill provides that, for purposes of this provision, the net gain from a subchapter S corporation (existing prior to the adoption of the Subchapter S Revision Act of 1982) will be treated as investment income if capital is a material income-producing factor in the S corporation, except for the income that is attributable to personal services of the taxpayer. The provision will apply to taxable years beginning after December 31, 1982 and will sunset December 31, 1984.

6. Treatment of tip income under FUTA

The bill provides that all tip income accounted for by an employee to an employer will be treated as taxable wages for purposes of the Federal Unemployment Tax Act (FUTA).

7. Taxation of regulated investment companies

a. Stock ownership of regulated investment companies

Under present law, a regulated investment company (RIC) is treated, in essence, as conduit for tax purposes. If a corporation is a RIC, it is allowed a deduction for dividends paid to its shareholders. One of the requirements that a corporation must meet in order to be a RIC is that it cannot be a personal holding company.

The bill modifies the definition of a regulated investment company (RIC) to permit a personal holding company (PHC) to qualify as a RIC. In the case of a RIC which is a PHC, any undistributed investment company taxable income of the RIC will be taxed at the highest corporate rate. Also, a corporation will not be eligible to elect RIC status if it has earnings and profits accumulated while it was not a RIC. This provision generally will be effective for taxable years beginning after December 31, 1982.

b. Timing of income from short-term Government securities

Under present law, the amount of discount income on short term government securities is includible in income at the earlier of the date of maturity or the date of sale.

The bill will allow a RIC to elect to include discount income on short-term government securities as it accrues. This provision is effective for taxable years beginning after 1978.

8. Installment payment of estate tax attributable to closely-held corporations

The bill amends the estate tax installment payment provision to permit consideration of the value of certain active business stock owned indirectly through ownership of an interest in a passive holding company in determining whether an estate qualifies for installment payments. The special 4-percent interest rate and 5-year deferral of principal payments will not apply to estates electing this provision.

9. Cooking wine

The bill expands the circumstances in which distilled spirits can be withdrawn from bond without payment of tax to permit tax-free withdrawal of such spirits for use in production of nonbeverage wines (e.g., cooking wine).

10. Nonprofit dependent care organizations

The bill provides that nonprofit day care centers (not located in a residence) qualify for tax-exempt status (under sec. 501(c)(3)), and eligibility to receive tax-deductible contributions, if both (1) substantially all of the dependent care provided to children by the organization is for the purpose of enabling individuals to be gainfully employed, and (2) the services provided by the organization are available to the general public. This provision is effective for taxable years beginning after the date of enactment.

11. Home for handicapped person won as prize

The bill provides that no interest or penalties will be payable on the Federal income tax liability attributable to receipt of a residence won as a prize, and specially designed for a handicapped foster child of the taxpayer, where certain conditions apply, but only if the tax liability is paid within one year after the date of enactment.

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